CLARIFYING THE STATUS OF INDEPENDENT CONTRACTORS——PART I

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND FINANCE

OF THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

WASHINGTON, DC, JULY 26, 1995

Printed for the use of the Committee on Small Business

Serial No. 104–43

U.S. GOVERNMENT PRINTING OFFICE

92–826 CC WASHINGTON : 1996

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-052576-4

CLARIFYING THE STATUS OF INDEPENDENT CONTRACTORS——PART I

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND FINANCE

OF THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

WASHINGTON, DC, JULY 26, 1995

Printed for the use of the Committee on Small Business

Serial No. 104–43

U.S. GOVERNMENT PRINTING OFFICE

92–826 CC WASHINGTON : 1996

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-052576-4

COMMITTEE ON SMALL BUSINESS

JAN MEYERS, Kansas, *Chair*

JOEL HEFLEY, Colorado
WILLIAM H. ZELIFF, JR., New Hampshire
JAMES M. TALENT, Missouri
DONALD A. MANZULLO, Illinois
PETER G. TORKILDSEN, Massachusetts
ROSCOE G. BARTLETT, Maryland
LINDA SMITH, Washington
FRANK A. LoBIONDO, New Jersey
ZACH WAMP, Tennessee
SUE W. KELLY, New York
DICK CHRYSLER, Michigan
JAMES B. LONGLEY, JR., Maine
WALTER B. JONES, JR., North Carolina
MATT SALMON, Arizona
VAN HILLEARY, Tennessee
MARK E. SOUDER, Indiana
SAM BROWNBACK, Kansas
STEVEN J. CHABOT, Ohio
SUE MYRICK, North Carolina
DAVID FUNDERBURK, North Carolina
JACK METCALF, Washington
STEVEN C. LATOURETTE, Ohio
JOHN J. LAFALCE, New York
IKE SKELTON, Missouri
RON WYDEN, Oregon
NORMAN SISISKY, Virginia
KWEISI MFUME, Maryland
FLOYD H. FLAKE, New York
GLENN POSHARD, Illinois
EVA M. CLAYTON, North Carolina
MARTIN T. MEEHAN, Massachusetts
NYDIA M. VELÁZQUEZ, New York
CLEO FIELDS, Louisiana
WALTER R. TUCKER III, California
EARL F. HILLIARD, Alabama
DOUGLAS "PETE" PETERSON, Florida
BENNIE G. THOMPSON, Mississippi
CHAKA FATTAH, Pennsylvania
KEN BENTSEN, Texas
WILLIAM P. LUTHER, Minnesota
PATRICK J. KENNEDY, Rhode Island
JOHN ELIAS BALDACCI, Maine

JENIFER LOON, *Staff Director*
JEANNE M. ROSLANOWICK, *Minority Staff Director*

SUBCOMMITTEE ON TAXATION AND FINANCE

LINDA SMITH, Washington, *Chairwoman*

JACK METCALF, Washington
FRANK A. LoBIONDO, New Jersey
WALTER B. JONES, JR., North Carolina
MARK E. SOUDER, Indiana
SAM BROWNBACK, Kansas
ROSCOE G. BARTLETT, Maryland
STEVEN C. LATOURETTE, Ohio
MARTIN T. MEEHAN, Massachusetts
WALTER R. TUCKER III, California
KEN BENTSEN, Texas
PATRICK J. KENNEDY, Rhode Island
JOHN ELIAS BALDACCI, Maine
CLEO FIELDS, Lousiana

LIGIA SALCEDO-MCWILLIAMS, *Subcommittee Staff Director*

CONTENTS

CLARIFYING THE STATUS OF INDEPENDENT CONTRACTORS——PART I

WEDNESDAY, JULY 26, 1995

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON TAXATION AND FINANCE,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:01 a.m., in room 2359–A, Rayburn House Office Building, Honorable Linda Smith, (chairwoman of the subcommittee) presiding.

Chairwoman SMITH. Good morning. I'm going to start this right on time because we have some unusual things that are happening. We will have a joint meeting of Congress this morning that we didn't plan. It came up at the last minute. So, I will give you the order.

What's going to happen is that His Excellency Kim Young Sam, the president of South Korea, will be coming, and so officially we have to adjourn this meeting, and start again after his presentation before Congress. What we will do with the Members approval is submit our opening statements for the record, and not take the time, so that we can make sure there is enough time for the panel of witnesses.

The reason that we are reviewing this particular issue is that we are trying to make a recommendation from this Subcommittee on what we think should happen with this issue, and we will recommend to the final committee of jurisdiction, what we think the small business community is asking, and what we think is the best solution.

Just last month, the delegates stated very clearly that this was their top issue, the small business delegates to the White House Conference, and it truly is. I was in business for many years, and probably one of the greatest problems I had, and my clients had, was independent contractors, and that was 20 years ago, and it hasn't gotten much better.

So, with that, we want to start, and I have a witness, Mr. Gene Wade, of Toledo whose written testimony we will submit for the record. The IRS has just moved in and decided that his whole industry will be determined to be employees instead of independent contractors, and it has nothing to do with the folks that work with his product. He is an independent salesman, but it shows how far this designation has come.

Now, we'll go to the two authors of two bills that are before Congress. Obviously both of these gentlemen have worked extensively,

both with coalitions, and I have read their proposals, and they have good recommendations.

What we would like to do is have them present before Congress officially what they would like to do, and then we'll have those that are affected by the independent contractor status, individual entrepreneurs, testify.

Then in the third panel, which will be at noon, we will hear from the groups that are trying to help small entrepreneurs resolve this. While some of the groups may not agree on everything, there is quite a bit of agreement from what I could see amongst them.

So, with that, I want to welcome Mr. Christensen, and Mr. Kim. I want to commend you both for the work that you have done. This is not an easy issue, but it's exciting that you're doing it, and it's exciting that you have picked up the top issue, especially for small businessmen and women.

So, while we have talked about small businesses, you have taken action behind that talk. So, Mr. Christensen, would you begin. You know where the rest of our colleagues are, at conferences, but we need to start on time with this. So, please begin.

[Chairwoman Smith's statement may be found in the appendix.]

TESTIMONY OF JON CHRISTENSEN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEBRASKA

Mr. CHRISTENSEN. Well, thank you, Madam Chairman, and I want to thank you for holding this hearing, because it is very important. I think you very eloquently stated the fact that this was the number one issue in the White House Conference on Small Business.

We have all seen the headlines in the last few years: "The IRS Wages War on the Self-Employed." "Rebuffing IRS Attacks on Workers." "Revenge of the Tax Man." The headlines go on and on.

Even yesterday, there was one in USA Today that I didn't bring along, but it was quite graphic. These are the recent articles on how the IRS has used murky, subjective criteria to target honest, self-employed entrepreneurs, and reclassify them as employees.

Let me lay out some of the background on this pervasive problem. Although in today's high-tech world there are many working relationships with businesses and individuals, the Internal Revenue Code classifies all such relationships into two categories; either you are an employee, or you're an independent contractor.

Some workers are categorized by law as one or the other. Other workers may be classified as independent contractors, with a reasonable amount of certainty under the safe harbors enacted in Section 530 of the Internal Revenue Code.

Those not fortunate enough to fall under these two classes are carefully scrutinized under the IRS' infamous 20-factor test derived from common law.

What does it matter whether someone is an employee or an independent contractor? This distinction is important because it determines whether the payor or the payee is responsible for the withholding of income tax, and the payment of FICA and unemployment. In other words, it has little to do with how much tax gets paid, but everything to do with who pays it.

Almost everyone will agree that the 20-factor test is unclear, and far too subjective. It is quite possible to take two seemingly identical situations, and find employee status in one, and independent contractor status in another.

Nevertheless, in recent years, the IRS has bludgeoned small businesses over the head with the 20-factor test, targeting truckers, florists, travel agents, computer programmers, and even ministers.

According to one recent estimate, the IRS' war on our Nation's job creators has resulted in the reclassification of 439,000 independent contractors, and the collection of $678 million in fines and taxes since the mid-1980's.

The IRS' actions have been especially deadly to small business people. Unlike their Fortune 500 counterparts, our Nation's small businesses cannot afford to pay the fancy tax lawyers and litigators needed to defend themselves against the IRS legal hit squads.

Consequently, rather than fighting the IRS and its use of the murky 20-factor test, many entrepreneurs are forced to close their doors, putting countless industrious Americans out of work. We will hear from some of those entrepreneurs today as a matter of fact. I've gotten to know a couple of the people who are going to be testifying in a little bit, and their stories are horrendous.

America's small business people have finally said enough is enough; and as you said, Madam Chairwoman, the White House Conference on Small Business named this as the number one issue. They had over 60 proposals, and this got the top vote.

The delegates recommended that Congress should recognize the legitimacy of an independent contractor, stating further that the current common law 20-factor test is too subjective. The conference delegates called upon Congress to establish realistic and consistent guidelines.

Those on the front lines have spoken and we've listened. On June 30th, just 2 weeks after the Small Business Conference, I and 100 original cosponsors introduced H.R. 1972, The Independent Contractor Tax Simplification Act of 1995.

Unlike past attempts to resolve this issue, H.R. 1972 defines who is not an employee. It establishes distinct, clear, and objective criteria for those seeking to perform services as an independent contractor. These new criteria may only be used if the independent contractor and the business for whom the services are being performed correctly comply with income reporting rules.

Specifically, H.R. 1972 establishes a three-part objective test for determining whether someone is not an employee. To qualify as an independent contractor, you must meet all three parts. Two of the parts contain subparts, but you must only meet one to satisfy that part. Let me go through the criteria briefly.

Part one: Investment. Does the individual have a significant investment in training or assets; or incurs significant unreimbursed expenses; or agree to work for a specific time, or complete a specific result, and is liable for damages for failure to perform; or receive compensation primarily on a commission basis; or purchase a product for resale. If the individual satisfies any one of these subtests, then part one has been met.

Part two: Independence. Can the individual demonstrate just one of the following subparts. The individual has a principal place of

business; or does not primarily provide the service in the service recipient's place of business; or pays a fair market rent for the use of the service recipient's place of business.

Or is not required to perform service exclusively for the service recipient, and has performed a significant amount of service for others; or has offered to perform service for others through advertising, individual written or oral solicitations, listing with agencies, brokers, or others; or provides service under a registered business or trade name. Meet any of these four subtests, and you satisfy part two.

Part three: A contract. Is there a written agreement between the parties? This helps clarify each party's responsibility for the payment of taxes, thereby aiding compliance.

That's it. Meet all three parts—independence, investment, and a written contract—and you qualify as an independent contractor.

But remember the independent contractor and the business for whom the services are being performed must correctly comply with income reporting rules. If they fail to do so, then they are left with the burdensome 20-factor test, and all of its traps.

It is important to note that my bill does not eliminate the 20-factor test, nor the safe harbors under Section 530. It simply provides for an alternate test that can be used if you comply with all income reporting requirements.

As a matter of public policy, our tax laws should not favor employee status over independent contractor status, or vice-versa. Individuals should be free to enter into business arrangements of their own choosing without the IRS pushing them into one category or the other.

Despite a well-documented record of discouraging independent contractor status, the IRS is now on record that it will not discriminate against independent contractors. Margaret Richardson, the Commissioner of the Internal Revenue Service, told delegates to the White House Conference on Small Business, that the IRS "does not care whether someone is an employee, or an independent contractor, as long as they properly report their income."

H.R. 1972 clearly satisfies her reasonable request, and I look forward to working with Mrs. Richardson on this important issue.

In closing, Madam Chairman I want to thank you and my colleagues on the subcommittee for holding this hearing today.

We are in a changing world. No longer will the majority of Americans earn a living in the fields and factories that many of us and our ancestors toiled in. Rather, we are at the brink of the Third Wave Information Age as Speaker Gingrich has so vividly described.

This new era will feature new types of employment relationships, where people can work out of their homes and "telecommute"; where individuals can service thousands of customers all over the world through the push of a button. It will foster the entrepreneurial spirit that has made this country great.

This new era has the potential of bringing enormous improvement to the lives of all Americans. Our laws should encourage, not hinder, this development. That's precisely why we need to adopt a new, clear, objective standard for determining who is self-employed, and who is not; a standard based on freedom, which allows those

who wish to benefit from this new era to do so. Thank you, Madam Chairman, for the opportunity to testify here today.

[Mr. Christensen's statement may be found in the appendix.]

Chairwoman SMITH. Thank you, Mr. Christensen. We would like to have Mr. Kim next. He does have to leave at 10:30 this morning.

TESTIMONY OF HON. JAY KIM, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. KIM. Well, thank you. Thank you, Madam Chairwoman. My colleague already stated beautifully, and his bill and my bill are about the same, except for what I will go over later. But let me add to what my colleague said, and that is that my bill was submitted almost a year ago.

The problem is that often if you hire somebody, like an independent auditor, or accountant, or a marketing consulting firm, and you thought that they were an independent contractor, or an independent businessman. Five years later the IRS comes down and audits your books, and says, I'm sorry, he should have been carried as an employee.

Can you imagine the penalties that he has to pay back—and all the FUTA taxes, FICA taxes; and not only that, since he is an employee, you have got to pay all the holiday, and sick leave, and vacation, and combine this together, sometimes it's about $200,000 per case, and all you have to have is a couple of those, and you're going to go out of business.

This is the horror story that I have been hearing. I was a small businessman myself, and I have had similar experience. So, that's why the White House Conference on Small Business recognized this problem, and they took this problem as their number one priority, and I'm glad of that, because I presented this problem a year ago to various small businesses.

So, all I'm trying to do here is correct the problem. Back in 1987, I believe, Congress passed a Section 530 Rule, which failed to clearly define what independent contractor means. It's not clear.

So, what happened is the IRS set their own regulations, their own rules, called the 20-factor test, as my colleague mentioned. It's arbitrary, and here it is, and if you don't meet the criteria, then automatically you are no longer considered as an independent contractor.

You go back and have back taxes, and back penalties, and there is nothing much you can do as an employer, and as a businessman. So, as my colleague mentioned, my bill is simple. The first half defines what the independent contractor is, and I'm going to tell you what that is. It's almost the same as his. Are you sure you didn't copy mine?

Mr. KIM. To be an independent contractor, you must meet one of four criteria: First of all, the worker must be able to realize a profit and loss. I mean, you have to have some kind of practical law. If you are an employee, you never have a loss. So, that's the first criteria.

Second, you've got to have some kind of a separate, physical place of business. You can't use the place that you are doing business with. You have got to have some kind of business place.

Third, you've got to have some kind of investment. You have to have a computer or something. You can't just say I am an independent business, and have nothing. Finally you have got to have some commission basis rather than a paycheck. But most of all, one mandatory is that you must have a written agreement between two parties, which spells out the scope of work, and duration of the services.

It is common sense, very common sense. Instead of all the complicated 20-factor test, all you have to do is look at it with very common sense. Now, the only difference between his bill and my bill is that my bill goes one step beyond.

My bill gives a tremendous break to small business owners, however, there are a couple of things they have to do in return. First of all, all the service providers, and this gets the independent contractor, must file an income tax at the end of the year, which would spell out individual services they rendered.

Right now they don't have to. It just simply says total amount of revenues is $500,000, period. After this bill is passed, they have to itemize, and at the same time the recipient, the service recipient has to even file a 1099. You must file a 1099, so that the IRS can match easily.

It only takes a couple of seconds to match it by computer. Right now there is no way they can match it, because service providers simply lump together as a revenue, and the 1099's spell out whatever service they receive, and it's hard to match.

So, they have to be under some obligation for making sure that they list individual services they rendered, and then the recipient has to file a 1099 so that the IRS can match.

The second inclusion I have, and which my colleague doesn't have, is if a business fails to issue a 1099 to the worker, then we are going to increase the penalty. Not very much. If you did it unintentionally, then that would be a $75 penalty per case instead of $50.

If you did it intentionally, then it increases to $125 per case. It's really a marginal penalty fee. Basically, that's it. I do have a 530 safe harbor clause which protects the employers, but those are minor provisions.

Basically, I just have gone a little beyond my colleague here, and that's about it. I'd be more than happy to answer any questions you have.

[Mr. Kim's statement may be found in the appendix.]

Chairwoman SMITH. Thank you, Mr. Kim. I have read both of your bills, and I like the basic concepts and principles of both of them. I would have drafted both of them slightly differently, but that's what this place is all about. In general, it looks like you used the recommendations of the GAO study of 1977; is that right?

Mr. KIM. That's correct.

Chairwoman SMITH. They were reasonable, and so I see where you're going, and I think that they are both well-drafted bills, and I like to see new concepts come together. But with that, I would like to introduce Mr. Meehan, and his opening statement, and then we will go right to questions so that you can get over to the presentation before Congress.

Mr. KIM. Sure.

Mr. MEEHAN. Briefly, I thank both of my colleagues for testifying here. Small businesses in my district agree that the 20-factor test used by the IRS to determine compliance is too objective. I, along with many of my colleagues, support the White House Conference on Small Business recommendations to establish a clear definition of independent contractors, including the existence of a written contract, and the realization of profit or loss, and a separate place of business, and payment of commissions.

But most importantly, I think it's crucial to include the small business community in any legislative clarifications of independent contractor status. It seems to me that too often the small businesses lose their voice in Government regulatory agencies.

So, again I thank you for your testimony, and I think that working together we will be able to legislate a solution to a nagging problem for the small businesses across the country; and as a Democrat, I look forward to working to a solution to this problem. Again, I thank you for your testimony.

Mr. KIM. I would like to propose that my colleague maybe would join this together and make one bill instead of two bills. They are about the same anyway.

Mr. MEEHAN. I have an inquiry as to who copied whose bill.

Mr. KIM. We copied each other.

Mr. MEEHAN. Maybe we could have a special hearing on that after the House hearing on this?

Chairwoman SMITH. I think when he says it's common sense, it was probably true. But, thank you. I'm going to start with questions, and I'm going to waive the chair's questions, and go to the first Member that was here, which is Mr. LoBiondo.

Mr. LOBIONDO. No questions.

Chairwoman SMITH. No questions. Mr. Baldacci.

Mr. BALDACCI. I just have a statement that I just have for the record, and I don't have any questions. I'm very pleased with the testimony, and as a follow-up to the White House Conference, I have a statement to that effect.

Chairwoman SMITH. I will submit that statement.

[Mr. Baldacci's statement may be found in the appendix.]

Chairwoman SMITH. You had quite a few members of this committee, both of you, on the bills don't you? So, you are tracking with——

Mr. KIM. Yes, quite a few.

Mr. CHRISTENSEN. We have 116 as of—as I said, when the White House Conference on Small Business identified this as the number one issue, and we went to work with it, we got involved with a lot of coalition groups, and find out exactly the different types of importance of items that come into a bill for them.

We worked together with them, and we introduced a bill 2 weeks after with 100 original cosponsors, and we have 116 right now. We hope to have this hearing, as well as before my Ways and Means Committee, and the Oversight Committee, and we would like to see this enacted by the 1st of 1996.

Chairwoman SMITH. Thank you. Mr. Metcalf.

Mr. METCALF. Thank you. My wife and I own a small business, and we're very aware of this problem, and I commend you for call-

ing this hearing, and commend you for doing it. I have no questions. I just have support.

Mr. KIM. Well, thank you.

Mr. CHRISTENSEN. I guess I would, Madam Chairwoman, I would like to tell my colleague as well for the record that I do appreciate his work in this area as well. It is an area where legislation is definitely needed. Basically, I see only three areas of differences in our bills, and he may have clarified one.

I have examined his bill, and I felt like his bill maybe tinkered with Section 530 of the Safe Harbors Act, and maybe it doesn't. But it was my interpretation that it doesn't with Section 530.

Second, H.R. 1972, I believe, gives more flexibility to the test, and as we look forward toward the 21st Century, there is going to be a lot of jobs that are going to come into play here that might not be your regular type of small business that was perceived in Mr. Kim's bill.

Third, I think Mr. Kim's bill leaves the criteria selection up to the Secretary of the Treasury's proposed legislation, and I believe that it is the responsibility of the Congress to propose that kind of criteria, and that's why we propose H.R. 1972. Is that correct or not?

Mr. KIM. By the way, I deleted that section.

Mr. CHRISTENSEN. You deleted that section? OK.

Chairwoman SMITH. If there are no further questions, gentlemen, thank you.

Mr. KIM. Thank you, Madam Chairwoman, very much.

Chairwoman SMITH. I think you are doing a great service.

Mr. CHRISTENSEN. You can go ahead and apply.

Chairwoman SMITH. Let's move to the next panel.

TESTIMONY OF FERN DENHOLM, OWNER, FLOWERS AND FERNS, BURKE, VIRGINIA, ON BEHALF OF THE SOCIETY OF AMERICAN FLORISTS

Ms. DENHOLM. Madam Chair and members of the subcommittee, I am Fern Denholm, testifying on behalf of the Society of American Florists. SAF is the only national trade association representing the interests of the entire floral industry.

In addition to being a member of SAF, I am the owner of Flowers and Ferns, a retail flower shop in Burke, Virginia, and a delegate to the 1995 White House Conference on Small Business.

I greatly appreciate the opportunity to appear before the subcommittee to discuss the implications of the definition of the independent contractor on small businesses. I would like to talk about three items today: The White House Conference on Small Business and the intent of the language drafted by the delegates; the impact of IRS guidelines and enforcement on businesses; and my own personal experience regarding the effect of the current guidelines and my ability to expand my business.

Before I begin, however, I would like to tell you a short story about how I became involved in this issue. A few years ago, I was maintaining plants in a large bank, and it took two employees an average of 3 hours twice a week for the care and maintenance of the plants.

At the time, I was beginning to expand in this service. Unfortunately, I became seriously ill, which required the employees who had previously been handling the plant maintenance to remain in the shop. We considered hiring an independent contractor to take over while I recovered.

But the definition of an independent contractor in the IRS guidelines were so complicated and contradictory we opted to terminate this portion of our business rather than expand it as was originally hoped.

It was at that time that I became aware of others who had similar problems, and realized that a change had to take place. For example, the White House Conference on Small Business, and the language and intent drafted by the delegates.

As a delegate to the White House Conference on Small Business, I was 1 of 1,700 small business owners who voted to make the definition of the independent contractor the top legislative priority.

In my written testimony, I have included the background of the White House Conference recommendations. In summation, the language indicates that the current independent contractor definitions are too subjective, and unrealistic.

The report suggests instead that an independent contractor meet one of four specific criteria, and agree to a written contract. Additional language intends to eliminate the back fines when 1099 forms are filed, and reassesses the penalty system that creates possible partnerships between employers and contractors.

Regarding the intent of the IRS guidelines and enforcement on businesses, the impact of the current regulations has made it extremely complicated for my industry to hire independent contractors. For example, in retail floral shops it is customary to hire contract designers during peaks times of the year, such as Valentines Day or during the wedding season.

One of the guideline questions asked by the IRS is does the independent contractor own his own tools. In our industry, most designers own their own knives, but as a rule, the shop owner provides scissors, wire cutters, and pick machines.

Therefore, the rule is not specific enough for me to understand if a contract designer could use their own tools provided by the contracting shop, and necessary to make an average floral arrangement, or if as an independent contractor, he must provide and use all of his own tools.

The results of an SAF survey show that it is common for employers in all segments of the floral industry to use independent contractors on a regular basis. Workers hired on a contract basis typically perform tasks such as piece-work planting, or design and driving.

Several years ago, a greenhouse owner hired workers from a cement contracting company to pour concrete at a greenhouse. The IRS fined the greenhouse owner because he had not claimed these workers as employees, although the individuals performed similar tasks contractually for other businesses.

It is virtually impossible for the small business owner to employ every type of laborer needed to maintain the business. From construction workers, to electricians, to designers, the small business

owner depends on being able to hire independent contractors on an as-needed basis.

IRS reclassification of an independent contractor as an employee has a drastic affect on the employer. Payment of back taxes, penalties and interest, in addition to providing that person with benefits such as health care and paid leave can force a small business to shut its doors.

My own personal experience regarding the effect of the current guidelines and my ability to expand my business is that if you have ever called your florist during a holiday, and they said, "I'm sorry, we can't fill that order for you," your reaction has probably been, "why don't they just hire more designers and drivers?"

We would be thrilled to do this, but because of regulatory restrictions and complicated and confusing guidelines associated with hiring an independent contractor, many retail florists have chosen to turn business away instead of dickering with the IRS.

Instead of hiring independent contractors as drivers, we have joined a cooperative delivery service in the Washington metropolitan area to cover a larger delivery area. At times, however, we have been forced to use costly, courier service.

Like other florists around the country, there have been occasions when we have not been able to keep up with the demand. Had we been comfortable with hiring independent contractors as designers and drivers, we would have been able to fill your flower order, and you would have been able to express your feelings with a beautiful floral gift.

In fact, I have avoided hiring independent contractors. This business decision has kept us from expanding some of our services, such as wedding coordination and plant care, into full fledged business services.

The independent contractor is a vital component of the small business community. Not only do independent contractors allow the small business owner to keep up with work place demands, but it allows fledgling business people the opportunity to build the basis for a company through independent contractor service.

In closing, I would like to thank Representative John Christensen and the other 100 original cosponsors of H.R. 1972, the Independent Contractor Tax Simplication Act of 1995, for addressing this important issue. The 104th Congress, and specifically this committee, has been very receptive to the concerns of small businesses and main street America. Thank you for taking the time to hold these hearings.

[Ms. Denholm's statement may be found in the appendix.]

Chairwoman SMITH. Good morning.

TESTIMONY OF DEBBI-JO HORTON, ACCOUNTANT, PROVIDENCE, RHODE ISLAND, AND NEW ENGLAND TAXATION CHAIR FOR 1995 WHITE HOUSE CONFERENCE ON SMALL BUSINESS IMPLEMENTATION TEAM

Ms. HORTON. Good morning. Madam Chair and members of the subcommittee, I have written testimony which I would like to have placed into the record, and in the interests of time, I would like to summarize my remarks.

My name is Debbi-Jo Horton, and I am the Elected New England Regional Taxation Chair for the implementation team of the White House Conference on Small Business, as well as the owner of a small business that's located in East Providence, Rhode Island.

I commend this subcommittee for giving the issue of independent contractors such timely consideration. 1,471 delegates to the 1995 White House Conference have placed this issue as the number one issue facing small businesses today. Recommendation 224 is detailed in my written testimony.

The subjectivity of the IRS 20-factor test can bankrupt a small business. The ramifications of the reclassification of an independent contractor to employee status is costly and often unfair and unreasonable.

An example of this is what happen to a Smithfield, Rhode Island company. They were contacted by the IRS and asked if an agent could contact them, and discuss the issue of employee versus independent contractor. They were assured that this was not an audit.

They cooperated, and shortly after the completion of the interview, they were contacted by the IRS again, and told that they would be conducting an audit of their employees and subcontractors.

They reclassified all subcontractors as employees, assessing penalties, interest and all portions of payroll taxes, totaling $72,000, and told that a certified check must be delivered with 24 hours, or a 150 percent penalty would be assessed.

The company hired legal counsel, and spent the next 2 years fighting the assessment, incurring $10,000 of attorney fees. The IRS ended up settling for $38,000, but required affidavits signed by each independent contractor certifying that they had paid their self-employment taxes.

I have reviewed the contents of H.R. 1972 and H.R. 582. They both provide a good foundation for change, but both fall a little short of the legislation we need to resolve this debate. Of the two bills, H.R. 1972 is closer to the needed wording to recognize the legitimacy of the independent contractor, and to clarify the Internal Revenue Code as it currently stands.

It does not, however, repeal the 20-factor test that is in the current Code, and it is essential to repeal the 20-factor test, and to codify the revisions of the final version of the bill.

The Taxation Implementation team from the White House Conference is willing to be part of a joint task force that would combine legislators and small business persons to discuss the needed changes.

The AICPA has also come forward with a safe harbor recommendation that would guarantee independent contractor status. If a client withholds 5 percent of the subcontractor's gross revenue, and remits the withholding to the IRS with the appropriate 1099 filings, and there is a written agreement, then the IRS cannot reclassify.

The White House Conference delegates discussed a 5 percent withholding option and determined that this was not practical or viable. Small business is overwhelmed with compliance regulations and paperwork as it is. Additional compliance in the form of subcontractor withholdings would create an undue burden.

The delegates to the White House Conference on Small Business represent the concerns of the employer, employee, and independent contractor. The burden cannot be passed on to the small businesses to make the independent contractor comply with filing their Schedule C and paying their share of taxes.

Most small businesses do comply with the reporting requirements for their independent contractors. Burdening them with withholding requirements would not promote additional compliance. In fact, it could very well reduce the amount of compliance.

For example, if the subcontractor refuses to work for a client if there is to be a 5 percent withholding, and that client needs to work with that particular subcontractor, he has two options; either not withhold, or to absorb the 5 percent themselves.

If he doesn't withhold, he fears a red flag alert by filing a 1099 with no withholdings, and therefore, will probably not file that 1099, and then the IRS has no way of knowing if that independent contractor is complying.

I am very appreciative of this subcommittee and the 104th Congress for making it a priority to streamline regulations. It is my opinion and that of 1,471 delegates that the independent contractor rules are the perfect place to begin.

I thank you Madam Chair and this subcommittee for giving me the opportunity to testify, and I welcome any questions you have.

[Ms. Horton's statement may be found in the appendix.]

Chairwoman SMITH. Thank you, Ms. Horton. I hear you are a constituent of Mr. Kennedy.

Mr. KENNEDY. Thank you, Madam Chair. I apologize for being late. I was in another committee, but I'm pleased to be on the subcommittee to hear this testimony from someone who is widely respected in my State for her work, and on issues related to the Chamber of Commerce, in particular. Her testimony here today concerns the independent contractor issue and how to simplify the tax structure with respect to that.

She makes some very good points about her objections to the 5 percent withholding across the board, and I think that is an important contribution to today's testimony, and I thank her for being here.

Chairwoman SMITH. Well, I do want to comment that most subcommittee members right now, because of deadlines, have two to three committees to sit on, and so it makes a great conflict, and I'm glad that you're here. OK. Mr. Johnson.

TESTIMONY OF PAUL JOHNSON, OWNER, P.J. NICE CONSTRUCTION, HANOVER, MARYLAND, ON BEHALF OF THE ASSOCIATED BUILDERS AND CONTRACTORS, INC.

Mr. JOHNSON. Good morning. Good morning, Madam Chair, and Honorable members of the subcommittee. My name is Paul Johnson, and I am the owner of P.J. Nice Construction, located in Maryland. I appreciate the opportunity to appear before you today to discuss the simplication of the independent contractor designation.

This issue is extremely important to the open shop construction industry, and I am pleased to speak on behalf of Associated Builders and Contractors, as well as my own company.

Associated Builders and Contractors is a national trade association representing approximately 18,000 contractors, and related firms in 81 chapters across the country. ABC's diverse membership is bound by a shared commitment to the free enterprise system, and the merit shop philosophy of awarding construction contracts to the lowest responsible bidder, through open and competitive bidding.

With 80 percent of the construction work force choosing to work open shop, it is an honor to be their voice before you today.

In the small business world, and in construction in general, independent contractors are often the perfect answer to a pressing need for special skills and know how for certain projects. The flexibility provided by an independent contractor provides numerous advantages for the business owner, as well as for the independent contractor.

It is imperative that businesses be able to make sound economic decisions about the classification of individuals as employees or independent contractors. Because of the importance of independent contractors to the construction industry, clarification of the standards that determine independent contractor status is critical.

The current 20-factor common law test is unwieldy. Because of the uncertainties surrounding it, it can lead to litigation and potentially to back tax penalties that can be devastating. Not only are the financial implications very serious for a small business like mine, but it is also upsetting to discover that a sound business decision made in good faith one day is a costly violation of the law the next day.

Independent contractors in the construction industry make significant investments in their own business. These investments include tools of the trade, vehicles, consumables, and specialized equipment. But the most important, and often most costly investments made by independent contractors in the construction industry is insurance.

In order for an independent contractor to do business with my firm, they must demonstrate that they have sufficient insurance coverage. Other investments may include travel from job to job, as well as any special clothing or personal protective equipment.

Finally, independent contractors in certain crafts must have earned certificates prequalifying them to work with certain materials or to certain standards. The nature of construction contracting necessitates commitments from independent contractors to compete certain tasks within certain time periods.

The only way a general contractor, such as myself, can estimate a job accurately for time and cost is to make sure that all independent contractors I contract with have an acute awareness of their schedules and the overall time line of the project.

The contracts that I use for my independent contractors make them liable for early termination. In cases where the contracts are task rather than time oriented, the independent contractor would be liable for damages for defective work.

The independent contractors I contract with also contract with other general contractors. Understandably, construction work cannot be simultaneously performed at more than one site. However, it is the nature of a project that tasks must be performed in a cer-

tain order, leaving down time between independent contractor performances.

Independent contractors often take advantage of these intervals to perform services for others. This is an ideal situation for all involved.

Despite these factors, which so clearly indicate proper designation of independent contractor status, the construction industry is repeatedly plagued by IRS audits and reclassifications. The IRS generally examines worker classification some time after the taxpayer has made its determination of the worker's classification, and after the taxpayer has filed its returns.

Thus, the reclassification by the IRS can result in severe penalties. Because the current system is unwieldy and unpredictable for the contractors involved, the ideal solution seems to be Congressional clarification of independent contractor status.

H.R. 1972 introduced by Congressman Christensen and cosponsored by Congressman Kim, both of whom addressed this subcommittee earlier today, addresses the problems faced by the construction industry.

H.R. 1972 has been endorsed by the Associated Builders and Contractors, as well as many other organizations advocating the proper utilization of independent contractors. This bill clears up the fog surrounding the 20-factor test and replaces it with a clear-cut option for businesses.

I cannot understate the value to our Nation of strong relationships between small businesses and independent contractors. Independent contractors are not only useful for businesses like mine, they are also the seeds of new small businesses.

I thank you for your subcommittee's attention to this important matter. On behalf of the Associated Builders and Contractors, I offer any assistance we can give you to resolve this issue.

Chairwoman SMITH. Thank you, Mr. Johnson. All right. Mr. Kane.

[Mr. Johnson's statement may be found in the appendix.]

TESTIMONY OF RAYMOND PETER KANE, OWNER, PISA BROTHERS, INC., NEW YORK, NEW YORK, ON BEHALF OF THE AMERICAN SOCIETY OF TRAVEL AGENTS

Mr. KANE. Madam Chairman, it is an honor and a privilege for me to appear before the House Small Business Committee on Taxation and Finance today. I am pleased to have the opportunity to comment on the independent contractor issue, and the two bills before the subcommittee.

The legislation would have a positive impact on the thousands of travel agency owners across this country. My name is Raymond Kane, and the name of my travel agency is Pisa Brothers Travel Service, which is located in New York City, and was founded in 1924.

I have owned and managed the agency since 1962. I also come before the subcommittee today as a long-standing member of the American Society of Travel Agents, also known as ASTA. ASTA is the world's largest and most influential travel trade association, with over 25,000 members in 136 countries.

Our members in the U.S. represent some 12,300 travel agency locations; 60 percent of the agencies are owned by women, and many of these women started as independent contractors, which enabled them to have their own businesses and accumulate the capital necessary to own an appointed travel agency; 185 percent of the employees are woman, and 82 percent of our members employ less than 10 people. The majority of the travel agencies in the United States utilize the services of independent contractors.

Over the years, agents have received mixed decisions from Federal and State tax auditors as to the status of their independent contractors. Since we are clearly small businessmen and women, we have had little or no recourse to challenge those audits.

In the 1970's, in accordance with a widespread industry practice, Pisa Brothers began renting space to independent contractors in exchange for a percentage of the commissions that they earned from the travel bookings of their clients; not Pisa Brothers clients, but their own clients.

This enabled these entrepreneurs to set themselves up in business without a large capital investment, and enhanced the earnings of my travel agency. During all of this time, we have scrupulously issued 1099's, reporting all income of the independent contractors to the Internal Revenue Service, and have abided by every 1 of the 20 guidelines that the IRS issued.

In August of 1991, I received a notice from the IRS that they wanted to conduct an audit for the fiscal year 1989. This audit took place over a period of several months, and resulted in a finding on February 18th, 1992 of no change, which, as you know, means that the auditor found nothing wrong.

During the 6 months that the IRS auditor was in my office, the contracts between my agency and the independent contractors were carefully scrutinized, and found to be in compliance with the IRS regulations regarding independent contractors, as indicated by the no change finding.

Two years later, with no change in the IRS rules, and no change in my contracts with the independent contractors, the IRS has decided that these same independent contractors were really not independent contractors all along, and were always employees. For the years '92, '93, and '94, the IRS is demanding $274,000 in penalties.

Now, how can you defend yourself against actions like this when the findings of the IRS on such an important matter can vary from individual IRS agent to individual IRS agent. In my industry, independent contractors are the most productive people.

They are typical of small business people who will go to any lengths to satisfy their customers to build their following, because this is their livelihood. Actually, the IRS probably collects more tax revenue due to the existence of these private contractors than if the same people were regular employees, and doing a routine job without the incentives that come from private ownership of their own business.

There is also a moral question here. These people have the right to be independent contractors. The IRS wants to deny them this right, not because they are not paying their taxes, but because it is easier for the IRS to monitor their payments as employees.

If the IRS has a compliance problem collecting taxes from independent contractors, it should deal with this problem on its own merits, and not try to change it to a classification problem in order to deny these people their right to be entrepreneurs simply for the convenience of the Internal Revenue Service.

In light of the recent actions taken by the major air carriers to cap travel agent commissions, this effort to simplify the definition of and independent contractor will be vital to us as more and more travel agencies look toward independent contractors to develop additional sources of revenue.

In conclusion, I hope you will support H.R. 1972, Congressman Christensen's bill, rather than H.R. 582, or H.R. 1083, because in my opinion H.R. 1972 is drafted in such a way as to provide the best protection for independent contractors. It clearly states the criteria that must be met to be classified as an independent contractor. This is so important if we are to remove the current confusion in the marketplace.

Thank you, and I would be delighted to answer any questions you or the subcommittee members may have at this time.

Chairwoman SMITH. Thank you, Mr. Kane. We'll hold questions until the end. Mr. Phillips.

[Mr. Kane's statement may be found in the appendix.]

TESTIMONY OF LOCKWOOD PHILLIPS, PUBLISHER, *THE CARTERET COUNTY NEWS-TIMES,* MOREHEAD CITY, NORTH CAROLINA, ON BEHALF OF THE NATIONAL NEWSPAPER ASSOCIATION.

Mr. PHILLIPS. Thank you, Madam Chairwoman. Madam Chairwoman Smith, and members of the subcommittee, thank you for having us here today. I appreciate this opportunity as a small business owner to talk to you.

I would like to ask that my written testimony, and accompanying letters from publishers, be made part of the written permanent record, and I will briefly summarize here to the subcommittee in a minute or two.

While I speak only for small newspapers, I speak for thousands and thousands of them across the country. Our problems in this area of the independent contractor are quite similar to those faced by large and medium-sized newspapers as well.

The principal problem newspapers have in this area are with the carriers that deliver the papers. The law has an exemption for youth carriers, but as the Nation's carrier force is shifting to be made up mostly of adults, the IRS seems to be picking out small independent newspapers, arbitrarily deciding that their adult carriers are not independent contractors, despite overwhelming evidence to the contrary.

Assessing fines, and penalties, as well as substantial back tax charges on the basis that they should have been paid as employees, and not as independent contractors, or that the contractor's own business expenses are disallowed.

We appreciate the efforts that Congress has made in the past to make sense out of this area of the law. Unfortunately, the IRS is able to bend or interpret those rules however it chooses during an audit.

In an effort to meet this problem, several Members of Congress have worked hard to come up with new legislation to clarify this area, and prevent further abuse by the IRS. While this legislation is a step in the right direction, it still falls short of providing what newspapers need to avoid IRS harassment in this area; harassment which is often aimed at the independent contractor, as well as the community newspaper, neither of whom usually have the resources to take on the Federal Government.

Our proposed solution is simple. That the National Newspaper Association, which I represent, and which represents small newspapers, work with this subcommittee to build into the proposed legislation a clear bright line, recognizing that newspaper carriers are classic entrepreneurs; small, independent businesses, providing a valuable service.

Clear and fair rules are needed, and we believe the subcommittee has chosen the right starting point. As it stands now, every small newspaper, and even more importantly, every small independent contractor doing business with a newspaper, stands hardly a ghost of a chance against an IRS audit.

All we are asking for is fair treatment, and nothing more, but nothing less. We are confident that few, if any, carriers would fairly be judged as employees. The way it is now is just the opposite. The IRS simply calls them all employees, and we have to hire lawyers to fight the Federal Government to establish what fair and objective tax administration would have given us without a fight.

To get that fair treatment, we need your help, which is why I am here today. Thank you for your time in listening to today's remarks. In the interest of time, I will save any other comments until later.

[Mr. Phillips' statement may be found in the appendix.]

Chairwoman SMITH. Thank you, Mr. Phillips. We have to recess, and we'll come back and take any questions. This is not the ideal. So, we will recess, and come back as soon as we can.

[Whereupon, at 10:53 a.m., the subcommittee was adjourned, and was again called to order by the chair at 12:07 p.m.]

Chairwoman SMITH. A brief explanation. Again, we had to adjourn for a joint meeting of Congress and that made an inconvenience for you, and I thank you for coming back. I also want to thank you for all the work that you are doing on this issue. The questions that we will take, we will take from Mr. Kennedy, and Mr. Jones has joined us, and Mr. Phillips is from his district.

Anybody that isn't here, if you have a legislator, is because we are running too many things at one time. So, with that, we are going to start questions; and I do want to tell you that I have looked at the language of the proposed bills, and I am concerned about some of the possible interpretations. I used to find too many questions unanswered, and I understand the purpose clearly. But I will just submit those in writing, because maybe we can work on tightening the final words.

Other than that, I do want to ask Mr. Kane one question, and it deals with the audit. Did you have two different auditors, or the same auditor?

Mr. KANE. It's the same auditor.

Chairwoman SMITH. The same auditor changed his mind?

Mr. KANE. Excuse me?

Chairwoman SMITH. The same auditor in both audits, or did one auditor——

Mr. KANE. Well, first of all, I think to be precise, the IRS refuses to call it an audit. They call it a compliance check. While that language is strange to me, my accountant explained to me that that leaves them a loophole by not calling it an audit, because if they are found in the wrong on the compliance check, they can still come back and harass me with an audit. Whereas, if they audited me——

Chairwoman SMITH. It's harassment.

Mr. KANE. OK.

Chairwoman SMITH. Thank you. I was going to say it sounds to me like you were harassed.

Mr. KANE. Yes. So, this—incidentally, the same auditor has gone to six or seven major agencies in New York City, and his attitude is apparent. He comes in—he spends a little time there, and he comes back. There is no attempt on their part to analyze any different people. They are all tarred with the same brush, irrespective of the contribution that is claimed that they made or not made.

I think what is really particularly bizarre in the travel business is that the independent contractors who are associated with me are not allowed by my contract with them to touch my clients. They are not allowed to talk to them, to phone them, or do anything for Pisa Brothers.

They have their own clients, and mutually I cannot bother their clients, because——

Chairwoman SMITH. You believe you meet the spirit of the law.

Mr. KANE. Well, not only the spirit of the law, because we've had many years with this 20 questions, and I think that any fair minded person would say that given the peculiarities of our particular industry that we have met the 20 questions.

The attitude is they are shooting fish in a barrel, and they found a wonderful way to raise a lot of money, and to aggrandize themselves individually because of remarks that the agents make, and which I find very inappropriate, but apparently they are not afraid of being quoted or anything.

Chairwoman SMITH. Let me ask you one question to clarify. So, it was the same person that did the audit, or excuse me, the compliance check?

Mr. KANE. The compliance check, yes. The man came in, and he said—well, first, they send you a letter. We want to do a compliance check.

Chairwoman SMITH. Two years later.

Mr. KANE. They make an appointment. Oh, no. Oh, no. I'm missing you. No, absolutely not. The audit, the actual audit for the fiscal year 1989, which was done and which was finished in early '92, that's a different auditor. He came in, on and off, for over a period of several months. He reviewed the contracts, and absolutely everything.

Chairwoman SMITH. That was an audit, and you were OK?

Mr. KANE. Yes, no change. Not a penny. They didn't even say I took a lunch that I shouldn't have taken. Everything was clean as a whistle.

Chairwoman SMITH. They looked at your contracts?

Mr. KANE. We handed him the entire pile of contracts. He went over them carefully in the presence of my accountant.

Chairwoman SMITH. Well, I'll tell you what I'm trying to get at. I'm trying to figure out their training, because I have had a whole lot of experience where I would have a client audited one year totally cleared, and some different auditor came in within a couple of years, and not only audit them again but find a problem, and it appears that the training was not consistent if two from the same department came up with totally conflicting decisions.

It points here to this legislation, because you should not have two people coming to different conclusions, and that means that the law does have to be changed. And, if there are audits, it doesn't surprise me, or excuse me, we will call one of them a compliance check.

Mr. KANE. Right.

Chairwoman SMITH. But they looked at you, and they came up with two different conclusions. The Internal Revenue Service has a problem in either training their agents, or the law is so difficult that they can't figure it out either. So, that's what I wanted to know. I also wanted to see if you were harassed, if you had two audits on the same thing and you came under harassment.

Mr. KANE. No, no.

Chairwoman SMITH. That would be all that I would have right now, and the first person would be Mr. Kennedy.

Mr. KENNEDY. Thank you, Madam Chair. It seems to me in listening to some of the testimony that there are clearly problems with all of the various industries with respect to the independent contractor.

But it seems as though the subjectivity with which the IRS appears to treat various independent contractors differently because of their various industries, leads to a problem of the industries coming together on any common ground to find a set of objective criteria that can be mutually agreed upon by everybody.

That's why it seems as though for one industry an independent contractor can pass the rules, and in another industry there is less clarity, and there is more subjectivity involved, and that's probably the reason why today there hasn't been any general agreement as to how to address this issue categorically.

I'd be interested in hearing from all of you, especially you Debbi, if you could tell us about what the White House Conference on Small Business is doing, in terms of the joint task force, to try to iron out various industries' problems as they see them, and find a common ground. Do you see opportunities that exist to find that common ground?

Ms. HORTON. I think that when the taxation committees of the White House Conference got together that was one of the major focuses. There are so many industries that have their own little quirks to them. This was the reason that we came up with the one of four, plus the written agreement.

Because almost every industry can meet one of those four, rather than all four, or in the case of H.R. 1972, you really have to meet three, and there are some of those that eliminate an industry be-

cause it can't meet one of those. As far as trying to form a joint task force, I think this testimony is probably the first step.

Mr. KENNEDY. Maybe some of the other panel members could address how they see things going forward. The Ways and Means Committee will ultimately have the authority to mark something up. Could you give us your insight as to the possibilities of something being marked up with the Ways and Means Committee.

Mr. JOHNSON. I think Ms. Denholm mentioned this morning in her testimony, the fact that she has wanted to grow, and she wanted to do more things with her business, but she has simply been scared to death of the tax consequences of making her own decisions. That scares the pants off anybody. That, to me, says it in a nutshell.

Mr. KENNEDY. Madam Chair, I don't know how the Ways and Means Committee may be proceeding with this, but how is this subcommittee going to work with them in addressing this issue?

Chairwoman SMITH. We're going to make recommendations as to what we think is best in the two bills, and work with the language, and to try and get some of the language worked out before it gets there. The coalition has put together—and there is a variety of differences in what they think they would want, and yet the language we consider, or I consider is still soft, and so we will be making a recommendation, and we could testify before the committee as to what we think it should be. Thank you. Mr. Walter.

Mr. JONES. Thank you.

Chairwoman SMITH. Mr. Walter Jones, I'm sorry.

Mr. JONES. I've been called worse.

Chairwoman SMITH. Mr. Jones. I call him Walter.

Mr. JONES. Thank you, Madam Chairman, and I personally want to apologize to the panel, because I was in a National Security markup, and I regret that I did not hear your presentations, and I look forward to reading the comments you made in your prepared statements.

I am pleased to have Mr. Lockwood Phillips, who is from Carteret County, which is on the beautiful coast of North Carolina, here today; and I would like to direct most of my questions to you, Mr. Phillips.

One is that those of you who are not familiar with the 3rd District of North Carolina, we are an eastern North Carolina coastal area, rural, and agriculture is big in our district. All my adult life I have always perceived the carrier that delivered the newspaper as being an independent businessman or woman.

I have been amazed, Madam Chair, by the fact that the Internal Revenue continues to get into more and more businesses in a way that I don't think they should. So, H.R. 1972 with you and others, even though it's not perfect, I think it starts to address some of the problems.

But I would like to ask Mr. Phillips if you would give the subcommittee your definition of a newspaper carrier, and the type of people who are in this business.

Mr. PHILLIPS. Thank you, Congressman. Madam Chairman, the situation in a newspaper is that we are so involved in producing a product such as a newspaper that we treat ourselves as a pro-

ducer and a wholesaler. We're not into retailing, and we're not going to get into that. That's a specialized business.

So, we seek independent carriers, and historically we have utilized youth carriers. The "little merchant," of course, is excluded from this legislative concern. Newspapers are, unfortunately, under greater stress due to competition with the Post Office and other organizations to seek a more secure delivery system.

So we have begun to look more toward adult deliverers. The result is, of course, that in this transaction something has fallen, and the IRS has decided that there is a major gap here, when in reality they are the very same people, but there is a difference in age.

As Congressman Jones pointed out, we take great pride in the fact that we do not look upon these carriers and deliverers as being related with the newspaper. They are in fact independent, and I appreciate that observation, because it proves that not only are they legally, but they are perceptually as well.

But to further answer your question, the deliverers are pretty much cut across the social-demographic lines, in the sense that we still have youth, but we also have a large number of family members, and retirees. In the case of the family members, they are using this system of delivering newspapers to supplement their income.

In some instances, I might add, in larger cities, they have gone beyond supplementing it, and turned it into a very lucrative business; to the extent that they are delivering not only one newspaper, but multiple products, competitive products I might add.

That is perceived as the best situation for a newspaper, because these people then take on the task in a very professional manner, assuring that the customers are receiving their products as anticipated, and as paid for.

It takes a great deal less management, of course, on the part of the newspaper. In the case of retirees and older people, that happens to be a matter of either people who have retired, and discovered that they retired too young in life, and are looking to stay active; or retirees who are looking again to supplement their income.

They have taken great advantage of this, and have proven to be our best source of delivery. But they are people who are working in an environment to supplement. They are not interested in being employees, and they do not want to be under controlled circumstances. Newspapers do not try to control them; again meeting the criteria of independent merchants, and independent deliverers.

But they also are able to deliver the product without being perceived as an employee of the publication, and without having to be held accountable, or guilty if you will, for that publication's philosophy, editorial stance, or what have you.

But the point is they are independent, and they are able to operate independently in that fashion, and primarily as second-income earning, and there are various instances where I can show you that it has proven to be very successful for people.

Mr. JONES. Madam Chair, may I continue with another question?

Chairwoman SMITH. Yes.

Mr. JONES. What do you really think—and again throughout many rural areas throughout America, and again I understand the importance of that independent carrier in your business, but what

do you see happening to the independent carrier, as well as the newspaper business if the Internal Revenue Service continues to harass the carriers, as well as in my opinion, the newspapers?

Mr. PHILLIPS. They are out of business, particularly the independent carrier. But also many of the rural newspapers, the smaller newspapers. They do not have the wherewithal to argue the case. In one instance, there is a paper in Arlington Heights, Illinois, just below Chicago, that has been fined a sizable sum, $5.3 million, for back taxes.

Fighting it to date amounts to $96,000 arguing that case. That's not an issue that is worthy of even discussion for a newspaper my size, or for the 4,000 newspapers that make up the members of the National Newspaper Association, and obviously in the case of an individual, an independent carrier, primarily a retiree. They will fold in an instant.

So, it's not an alternative. It's definitely not an alternative, and the best thing is that it has been working, and it is acceptable today for youth carriers. The only thing is that you move that individual in age from, say, 10 to 14, or 10 to 16, to the age of, say, 28 to 60, and then something changes. We haven't figured out what that change is.

But it is the same individual that is doing the same job, and in the case of the older carriers, they are actually conducting businesses. They have expenses, car expenses, and fuel expenses, that they have to recoup out of the sale of newspapers, and they get no benefit from their contracting agent.

So, we have yet to figure out exactly what's changed in their business, and if there's been a sizable change.

Mr. JONES. Madam Chair, one more question.

Chairwoman SMITH. All right.

Mr. JONES. This would be to Mr. Phillips and other panelists, because I was not here to hear this discussed, but it is my understanding that Ms. Horton made the comment that the 20-factor test—is that correct, the 20-factor test—should be repealed, and neither the Christensen or the Kim bill, neither one repeals this factor test.

I will ask you, first, Mr. Phillips, and then others, your opinion on the need to repeal the 20-factor test.

Mr. PHILLIPS. Without question. It's subjective, and it's allowing for interpretation, and interpretation is based on an individual, and how that individual feels for that particular day.

The industry provides 1099 forms. There is no desire, no interest in avoiding the responsibilities of reporting on our independent contractors who are in our own operation. The difficulty when you are getting into a subjective fashion of that nature is that even after you proceeded to apply the law, you are held accountable for the interpretation.

That's after the fact, and it turns out to be punitive. It is not a guide. It's a punishment.

Mr. PHILLIPS. All right. Mr. Kane.

Mr. KANE. That sums it up. It's like the average shoe size is nine, but nobody in the whole country wears a nine. Well, this list of 20 questions, you could play it either side. If I work for the IRS,

I can find you are not in compliance. If I don't work for the IRS, I'll find the other way.

The problem is that all the power lies on the side of the IRS, and no power on the side of the small business, and so therefore the 20 questions have to be either changed—something has to be done about them.

But I think the bill states—I think that the bill of Mr. Christensen is that if you meet this criteria, you don't fall back on the use of the 20 questions. I think his bill only says if you don't meet this criteria, then you take your chances with the 20 questions, and the traps that lie therein.

So, still I think—and I also think, moving a little further, to have one criteria, set of criteria, for the many industries is going to be very, very difficult, because what's applicable in one industry may be simply not applicable to another.

Without making it even more cumbersome, there could be a series of things for like 15 major industries, each one could have its criteria of who is a private contractor or not. I'll give you a specific example. In my industry the access to the most powerful tool is the CRS System to make the reservations.

Nobody can own that. So, for the IRS to say that the private contractor doesn't is absurd. I don't own it either. The airlines own it. They lease it to me. I sublet it to the private contractor. So, how in the world can you make a criteria when the most important tool in my industry has to be owned when it's impossible to own it by anybody.

That's an example of where there is really no intelligence in these for the criteria of measurements.

Chairwoman SMITH. I think the question that is coming up is whether you leave the 20-factor test. They are leaving the Section 530 safe harbors, it seems that everyone believes that should be left in, and if there is a difference, please speak.

They also are leaving the 20-factor as a safety net, but adding this on top of it. So, if someone qualified on something else, they are not frightened of this bill. I think that's what's happening, and if that's wrong, would someone please comment on that; and then Debbi, would you please tell us why if somebody qualified under that, it should be qualified, and why you think it should be removed.

Ms. HORTON. Well, I think that the reason is that if you qualify under the guidelines that Mr. Christensen has put into place, then you clearly are an independent contractor. If not, then you're still getting trapped by the subjectivity of the IRS, and whether or not the agent is taught in one manner or another.

By leaving the 20-factor test in, you're going to have the IRS agent coming in and trying to make sure that you fall into that 20-factor test, and not the safeguard, so that you're open to the IRS's subjectivity, and all the penalties of reclassifications.

What needs to be put in the 20-factor test place is something that should be able to be met by everyone who truly is an independent contractor, which is why the White House Conference delegates came up with the one in one in four test because we could not come up with one industry that would not fit into one or more categories.

Chairwoman SMITH. So, your fear is that if you don't—it becomes an excuse for confusion possibly?

Ms. HORTON. Exactly.

Chairwoman SMITH. It would cause more problems. Any other questions from the Members?

[No audible response.]

Chairwoman SMITH. Thank you very much for coming, and your tolerance of waiting. If the next panel would come up. Mr. Schneier, you're first.

TESTIMONY OF ABRAHAM L. SCHNEIER, COUNSEL, MCKEVITT & SCHNEIER, WASHINGTON, DC, ON BEHALF OF THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. SCHNEIER. Thank you, Madam Chairwoman, my name is Abraham Schneier, and I am a partner with the firm of McKevitt and Schneier, and I am here on behalf of the membership of the National Federation of Independent Business. NFIB is the Nation's largest small business advocacy organization, representing more than 600,000 small business owners in all 50 States and the District of Columbia.

Typically, an NFIB member employs five people, and grosses $250,000 in annual sales. I want to thank you for the opportunity to appear before you today to discuss the current proposal to reform the law for determining independent contractor classification on small business.

I think as you have seen, this issue has been around a long, long time, and as a practitioner yourself, you realize how difficult it has been. Having been a practitioner, and also having a previous life as an IRS agent, I've had an opportunity to see it from both sides of the table.

I guess my conclusion is that neither side is being served adequately by the existing situation. Both sides are finding the situation confusing. Taxpayers obviously feel they are being abused, and I think the IRS, in its own defense, is probably saying how do we get a handle on this, and how do we ensure that we are adequately seeing the reporting of income.

I think that's the approach that we tried to take with the Christensen bill. Working with the Small Business Legislative Council and other organizations, NFIB tried to find an approach that would encourage the reporting of the—to eliminate the under reporting of income.

To make it such that if you did not adequately and properly report your income, and fall under the Christensen safe harbor, that you would then have the hammer of the old law, which would be the existing 20-factor formula.

Granted, this proposal is probably not perfect for everybody, and granted, it's a fact that there are some who would probably prefer to stay with the existing Section 530 Safe Harbor in some cases, and those are issues that are, I think, going to have to be melded as we move forward on this.

But I think again our focus was to seek as much as possible to create the incentive for proper reporting of income, and once having achieved that goal, to try and deal with some of the other questions that might come up.

I also would note that the IRS itself had stated that they—maybe not as an official position, but I believe at a speech that was given at the White House Conference on Small Business, or a presentation made at the White House Conference, that Commissioner Richardson herself said that the IRS had no interest in whether or not an individual was an employee or an independent contractor so long as income is being properly reported.

We feel that that is an approach that probably would help move this process forward. We're hoping that with the Christensen bill having been introduced, and with the hundred cosponsors, that there will be an opportunity shortly to try and address this problem, which has been an open sore for just way too long, since 1978, which is kind of when I became aware of the legislative efforts in this area.

We're looking forward to working with you, and with the other members of the subcommittee, and on the Ways and Means Committee to try and address this problem in hopefully the nearest future. Hopefully—I don't know if there will be an opportunity this year, but hopefully before the end of this Congress, because as you can see, many small business owners are facing the problems of the IRS today.

Many of them are facing the difficulties of trying to determine how to set up a business, and how to run their business, and we would like to be able to give them a clear guide for establishing their criteria, and for properly reporting their income so that all taxpayers will have a competence level in how to run their businesses.

Thank you, and I hope to answer any questions that you might have.

[Mr. Schneier's statement may be found in the appendix.]

Chairwoman SMITH. Thank you. We do have a series of questions, and we would like to go through some of those with all three of you. Mr. Satagaj.

TESTIMONY OF JOHN S. SATAGAJ, PRESIDENT, SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. SATAGAJ. Thank you, Madam Chairman, and I appreciate the opportunity to testify here today. I am John Satagaj, President of the Small Business Legislative Council, which is a permanent coalition of trade associations. This is, as you know, or you are finding out, the two-hat panel before you today. As Abe mentioned, he is a practitioner, as well as representing the NFIB.

I am also a tax practitioner on the legal side and Benson will tell you in a couple of minutes he is also a practitioner on the legal side. So, we bring both a policy perspective, as well as the front line perspective to this issue.

Unfortunately, all three of us have also been working on this issue since the late '70's. You have my written statement, and I'm not going to address anything that's in the written statement, but just make a couple of additional points.

One is that we're in this dilemma because we're wrestling with the tension between classifying individuals as independent contractors and tax compliance. What we're trying to do here is solve tax

compliance problems with the classification of individuals as independent contractors or employee.

As Abe discussed, as long as we continue to do that, we're always going to have a problem. I certainly hope that the Commissioner is comfortable with the statement that she made at the White House Conference, because she is going to hear it a thousand times for certain, because that really is the issue here.

Can we remove the issue of how we're supposed to classify from how you achieve compliance? Now, from our viewpoint, just like the Commissioner said that day, and Abe has just said, and Benson will say in a couple of minutes, we don't think it makes any difference for tax task purposes.

It used to be there was a differential, as you know, between the FICA situation and self-employment tax. Well, we kind of wiped that out along the way, and there was no incentive any more in making a person an independent contractor, or an employee, for FICA tax purposes. That's gone. That's not an issue any more.

FUTA is not an issue, because if you're an independent contractor, you're not going to claim unemployment compensation. So, that's not an issue. Withholding really becomes the key issue in this whole process. The withholding that you withhold if someone is an employee that you don't have as an independent contractor.

Now, I think at some point—I can tell you that I'm sure you've told all your clients, and I've always told my clients, that look, it doesn't do us any darn good if there is independent contractors out there who aren't paying their taxes.

We have to have a system where they are all paying the taxes, and if you happen to be the recipient of those services from an independent contractor, you better darn well tell each one of those independent contractors I expect you to be paying your taxes out there, you know? That's part of the system.

Until we encourage that, we're going to have a problem. Having said that, we know that we always are going to have to classify individuals for one reason or another, whether it's employment taxes, or it could be income taxes, and it could be FUTA taxes, or whatever the case is.

In working with Congressman Christensen on this legislation, we tried to find a common denominator that would work, and that brings me to my second point.

If we talk about this as if we set up a business, and we're going to do this in the world, and we're going to make a determination of independent contractor, or employee, we should look at each person, and see if they fit.

The truth is that maybe there are a hundred or so occupations that have developed since the '50's that are called independent contractors services. But there are 300 that were long in place before there was any issue about employment taxes, and they've got all kinds of idiosyncrasies about how they do business.

You heard about the newspaper carrier, and you can talk about construction, which you have. I mean, we have had journeyman construction laborers since the beginning of time, before we were worried about employment taxes, and there were always independent contractors who went from job to job.

So, we're trying to fit something that has been around since the beginning of time into a system we basically have only had for, I guess, 50 years. I can't recall exactly when we began employment taxes. We're trying to impose that system on practices that have been used for a longer period of time.

When you look at our legislation that Congressman Christensen has developed, and that we support, we're trying to accommodate all of it. It isn't perfect. I mean, I welcome your involvement in this, because, when everybody calls up, and when you start changing the language, maybe they will call you instead of us, and say why are you doing this.

Chairwoman SMITH. But we will be the ones taking the heat.

Mr. SATAGAJ. Right. You can take the heat. The last point is that we tend to think of the IRS as monolithic. There is this huge IRS Building downtown, and it's controlling everything.

But, as you well know as a practitioner, it's very decentralized; and right now the anxiety level amongst small businesses, whether they are the independent contractor, or the recipient of the service, it's higher than ever.

I brought just a couple of examples today that I will share with you. They're not in my written statement, and I will give you copies of them so that they will be in the record, of just the IRS running amok right now.

[Exhibits can be found in the appendix following Mr. Satagaj's written statement.]

In the Fresno office, they have a pilot program going on which stunned me, and I think it will stun you as a practitioner, too. Up to this point, we have been fighting this as an employment tax issue, and so the IRS generally goes after the service recipient, the business that uses the independent contractor.

The Fresno district is sending out letters, apparently in a pilot program, and they are sending them to the independent contractor, and this is how it begins. "Based on the information contained in your Form 1040, we have determined that filing a Form Schedule C is inappropriate to your situation. The tax return information indicates that you are not self-employed."

Chairwoman SMITH. They're fishing.

Mr. SATAGAJ. I would submit to you, based on what information in the 1040 and the Schedule C, can you make that determination? I know that I can't make it, but they apparently are making it.

So they're telling these folks we're taking the information that comes on your Schedule C. You take the amount from the Schedule C—that's where your filing your return—and put in a line in the 1040 that's a little bit lower down as you know from where wages are reported on the 1040.

Well, they're moving that information, and saying it's wages, and then they are disallowing all deductions in this return, and they send them this nice little letter.

But you're going to love the second letter in this program even better as a practitioner. They're sending to the practitioner who filed these returns for the independent contractors—to the practitioner—"We have identified you as a professional tax preparer who prepared returns for the Fresno Service Center during the filing season." "At least—fill in the blank—of your returns you prepared

had a Form Schedule C attached. We would like to inform you that we will be reviewing all these tax returns. We are requesting your assistance to advise your clients that they should be made aware of the requirements of being an employee."

Then I love this line on the end. "If returns that you prepared are found to be incorrect or inappropriate, there may be further contact with you." Welcome to the world of malpractice insurance. That was a problem with Fresno.

I know that I'm running late here. I have two more quick ones.

Chairwoman SMITH. We will file that with your statement.

Mr. SATAGAJ. Thank you. The second letter here—that's Items 1 and 2. Item 3—and this is going on in Iowa right now—Section 530 is the catchall safe harbor, and you've heard it talked about several times now, in which if there is a judicial ruling, past audit, or a longstanding practice, you might get relief even if you don't fit the common law.

The IRS office in Iowa is sending out a letter saying cold, and this is with no prior contact with the taxpayer or anything, or a determination of the common law. Nothing. Nothing. It's a cold letter.

"Our records indicate there may be a discrepancy in the classification of your workers for employment tax purposes. In order to make a determination, we would appreciate you providing in any and all cases rulings or other support upon which you relied as demonstrating that your action was reasonable in treating any workers as independent contractors. This request specifically refers to Section 530."

In other words, they've fast forwarded right through the entire process of determination, and have jumped to 530, and saying you had better tell us. Well, most taxpayers who call me said what is 530, and what do you mean, and how did they figure out that I need to get this relief, and if I try to get this relief do I give up the common law.

I don't know how many people have gotten this, but I can tell you at least two taxpayers in completely unrelated industries got the same darn letter, right down to the handwritten signature, which is obviously xeroxed, because they are identical in both cases.

The fourth example I'll give you is one that actually did come out of the national office. It didn't get as much attention. Earlier in January—and this is an article from Forbes Magazine—the IRS created a program, and they may have killed it since January. I don't know.

They have a computer program with artificial intelligence. The artificial intelligence is to replicate the determination process. What it does, and they're proud to say, is that it will take the same facts, and this computer will come up with the same results the Revenue Officer will come up with.

That, I think everybody in the room can figure out, is exactly the problem. When it comes out 99 percent of the time the same as the IRS is currently determining folks to be employees, then we do indeed have a problem.

In fact this article cites the fact that—I think it was in the Chicago office—99 percent of the determinations concluded that the individual was an employee.

So, now that the IRS has artificial intelligence, they can do it and get rid of all of the staff, and I guess we'll save some money in the process. I'll submit all four of these for the record. These are just examples that right now the tension level in the small business community is as high as it possibly can be.

Even though we've been dealing with it for a long time, the anxiety level is high; and in conclusion, and these guys have heard me say this many times, we've all been working on this since the 1970's, and I often say that when we die, what it's going to say on our tombstones is "Still working on the problem of independent contractors."

So, I welcome your involvement, and this subcommittee's involvement, and I think all of us would like to erase that from the tombstone in the near future. So, thank you for the opportunity.

Chairwoman SMITH. Thank you, Mr. Satagaj.

[Mr. Satagaj's statement may be found in the appendix.]

Chairwoman SMITH. Thank you so much. Mr. Goldstein.

TESTIMONY OF BENSON S. GOLDSTEIN, LEGISLATIVE AND TAX COUNSEL, NATIONAL ASSOCIATION FOR THE SELF-EMPLOYED

Mr. GOLDSTEIN. Thank you. I'm Benson Goldstein, the legislative and tax counsel for the National Association for the Self-employed. NASE has about 320,000 members nationwide, who are self-employed, primarily unincorporated businesses. They are the independent contractors. They're not the small businesses who hire independent contractors. They are the independent contractors themselves.

So, they are really on the front lines and concerned about this issue. What I would like to do with my testimony really is that instead of talking about tax compliance, I'd like to talk a little bit about the history on this issue, and then really go into why some Members of Congress have had tire tracks over their back—they have been run over on this issue over the years.

I think that the 1990's are different than 1978. Second, I would like to really talk a little bit about the revenue loss concerns on this issue, and why in fact you can go forward and accomplish something really positive in this area.

1978 really was the year when Chairman Rostenkowski was the subcommittee chairman. He wasn't the full committee chairman. He was the subcommittee chairman who dealt with this issue. He was unable to resolve it for all the reasons I think you've heard.

In the middle '80's, Rostenkowski was being chased down the streets by senior citizens for various reasons for another tax issue, but at that time he was dealing with 1706, involving computer specialists, and it still hadn't been resolved at that point.

But really why is it different now? I think really that in 1989 to 1991 you had probably the deepest recession that this economy has seen. Hundreds of thousands of people were laid off by large companies, and it was a situation where we now have moved from what might have been considered a flexible work force at that time, to a more flexible work force.

What you really have is that the dynamics of the economy have changed dramatically since 1978. Whereas, in '78, and maybe even in the middle '80's, this issue was primarily a small business issue. It's not primarily a small business issue any more, and maybe that's the reason why it's going to get resolved.

It's also a big business issue as well. Companies like IBM are hiring independent contractors. It's across-the-board with large companies. I was, several years ago, the tax policy manager for the U.S. Chamber of Commerce, and saw that, that it was no longer just a small business issue.

I think there will be a coalescing together regarding getting this issue resolved sometime in the short term. If one reads the language in the two bills, no language is perfect, as Abe and John have said. But I think we all want to work with this subcommittee, and work with the Ways and Means Committee to get this issue resolved.

Really, in terms of the revenue concerns, I think you can go forward, especially when you're talking about dealing with a 7 year budget window, and trying to go to a zero budget, or whether with the President's, it's a 10 year budget, and to go to a zero deficit. You can do this issue.

I think IRS Commissioner Margaret Richardson has made recent speeches saying that there is about a $2 billion revenue loss per year due to the misclassification in the eyes of the IRS for independent contractor status.

But really we disagree that there is a revenue loss in this area, because I'm going to borrow some testimony from the U.S. Treasury. "In his 1993 testimony before the House Government Operations Committee, Treasury Department Deputy Benefits Tax Counsel J. Mark Iwry, stated that "Deliberate misclassification may tend to result in net revenue losses to the extent that misclassification is undertaken to obtain a net tax benefit for the employer and the worker.

However, he also stated that "It is impossible to determine a priori whether misclassification tends, on average, to result in a net revenue loss or gain."

Iwry noted a very significant reason for this revenue impact analysis. He stated that "current Federal tax law does not consistently favor status as either an employee or an independent contractor."

Really the key there is that, OK, maybe there is, yes, possibly a misclassification out there, but we're talking about on the broad economic scale of getting a solution in this area, in terms of what will that solution mean to an impact on the budget process.

Based on that testimony, there really is no general revenue loss here. I mean, yes—or there was, I think, a revenue estimate done on the Kim bill, which I think is something like $500 million over a 5-year window. Again, we're not talking about a lot of revenue for an issue that has such dramatic implications for the economy.

So, really, I think that the time is now, and I think the economy is different, and that's why we can resolve this, as opposed to why it was not resolved in '78 or in the middle '80's.

With that I would like to close, and I thank you very much for inviting the National Association for the Self-Employed to testify today.

[Mr. Goldstein's statement may be found in the appendix.]

Chairwoman SMITH. Thank you. We'll go to questions. I do have one that I would like to ask all of the witnesses, and the question I would like all of you to address is in the Small Business White House Conference's report, they dealt with the issue of an IC–99 form, or some kind of a reporting of income, but it is not in the Christensen bill.

I understand why you might not deal with the 5 percent withholding, but I have trouble understanding why you dropped the IC–99 idea. Oh, excuse me. Oh, the White House Conference dropped it.

Mr. SCHNEIER. Right.

Chairwoman SMITH. So, it was dropped at that level.

Mr. SCHNEIER. It was dropped by the delegates themselves.

Chairwoman SMITH. They dropped it themselves?

Mr. SCHNEIER. Yes.

Chairwoman SMITH. That seems to be a way of getting around some of the objections on economic——

Mr. SATAGAJ. I think you've raised a very—I think there is a legitimate point, and I did try to get to that in my testimony, is that if the issue is compliance, there are solutions to compliance, and whether it's another form or something.

If we're talking that these independent contractors are not paying their tax, then we can find ways to deal with that problem, and it shouldn't be because of classification. That's the misnomer of misclassification.

They're not misclassified, and that's why we're losing $2 billion in revenue. It's because they're not paying the tax, and I think you've come right to the point, is that if there are other compliance issues, let's find them, and maybe another form—I think they were calling it the IC–99 is what they called it.

Then maybe—there are other compliance things that we can do, but I'll tell you right now I'm not prepared to talk about compliance unless somebody is willing to sit down with me and say, all right, we're going to clean up the classification aspect of it.

If this is the criteria, then fine. I'll sit down, and I'll talk all the compliance things you want, you know.

Chairwoman SMITH. Mr. Schneier.

Mr. SCHNEIER. I think on that issue also it's hard to—if it is part of the process to talk about compliance. I agree with John, but we are I think very much open to looking for solutions. None of the small business groups are interested in seeing revenue lost for the Treasury.

They're not out to say that we are not concerned to try and save—to stop the problems of the people who are purposely misclassifying. We really want to get this issue resolved for the 95 to 98 percent of the universe that are having problems in this area.

Chairwoman SMITH. OK.

Mr. SCHNEIER. Similarly I think that withholding has been seen as sort of a silver bullet on this kind of an issue, in terms of trying

to increase the compliance. However, for many small business owners, in the early years they may not make any profit.

Chairwoman SMITH. I don't agree with the 5 percent withholding, but I don't see a problem if we're all doing 1099's and everything else.

Mr. SCHNEIER. No, clearly increasing 1099 compliance and maybe some additional form that goes along with that would certainly be something that could be considered.

Chairwoman SMITH. Just in conclusion, and then we'll go to Mr. Kennedy, I think that my experience in the small business community is pretty extensive, and blue collar workers are trying to develop small businesses, and they are terrified of the Internal Revenue Service. So, they are actually not creating jobs because of their fear. They are not taking the opportunity because of the fear; and the fear alone is stopping them from creating jobs for others, and expanding their businesses a little further.

So I don't believe any of these economic analyses could be static and not dynamic evaluations, because I think you release the economy when you take the foot off the neck on this one. I think you have the foot on the neck.

Mr. SCHNEIER. Well, we fully agree with you. I think that unfortunately in the way the revenue estimated process has been done, it's been static estimates, and I'm sticking within the traditional notion of what revenue estimating has done.

But in terms of really taking the foot off the neck, I fully agree with you that the dynamics of the economy will just blossom, and that there will be job creation, and there will be actually increased revenues due to the job creation in itself.

Chairwoman SMITH. I'm going to submit to each one of you a list of questions on the Christensen bill, and the language—and to see if we can deal with that, rather than have it public right now. Mr. Kennedy.

Mr. KENNEDY. Thank you, Madam Chair. I would like the panelists to address that previous question once again with respect to the proposal by the American Institute of Certified Public Accountants with respect to the 5 percent withholding, and what your opinions are on some of the problems that could result from that for various businesses, depending on what kind of independent contractor they are. Would you comment further on that.

Mr. SCHNEIER. In general, too many small business owners, 5 percent could represent a total profit for a year. Not all independent contractor situations have that high of a gross profit margin, and where that would not necessarily be a problem.

For small businesses, their biggest problem is cash flow, cash flow, cash flow, cash flow; and to the degree that 5 percent is being held aside, you're really infringing on their ability to continue to pay off their suppliers, to maybe deal with employees, or other independent contractors they're utilizing for specific services.

So, it really puts them in a difficult position of having to rely on other sources of credit in some cases. Third, is that in the early years, small businesses and independent contractors maybe have very little in the way of profits, and there is no way to reflect that in just a straight across-the-board 5 percent holding situation.

Mr. SATAGAJ. I think Abe has said all the key points. The biggest thing is defining gross profits. That is an issue in general, and if 5 percent of gross isn't 5 percent of your livelihood, and if you're trying to take it out of gross, you're just going to have an enormous problem for the independent contractor.

Mr. GOLDSTEIN. Really another look at it would be the income fluctuations over the course of a year for a business. They may make a tremendous amount of income in 1 or 2 months, and then—or they may have a reverse of that, and have tremendous expenses in 1 or 2 months, and because of the income fluctuations, I think I am very much concerned about imposing withholding in that kind of situation.

So really it would actually end up with a hardship on that business.

Mr. KENNEDY. Well, I appreciate that testimony, and it echoes previous testimony, and I'm pleased to see that there is a pretty broad degree of support, or opposition I should say, for that one size fits all approach.

Like other members of the subcommittee, I think I speak for everybody when we say we want to find something that defines the rules of the game from the get go so that businesses don't find themselves getting reclassified later on, and having to bear the burden and the brunt of all kinds of penalty fees based upon someone else's misclassification of your status, and I really am grateful for the subcommittee chair to have undertaken this hearing, because I think this further expands the discussion.

To the extent that we can arrive at some way of eliminating this sort of gray area, I think a lot of people can rest easier, because one way or another they will know from the outset where they stand. They probably won't have any problem—they may have problems with one or the other, but at least they don't have to worry about getting shifted back and forth, and then incurring all sorts of penalty fees in the process. So, I thank you for your testimony today.

Chairwoman SMITH. One thing that will be addressed next week is the issue of the 5 percent, and I think by then the AICPA—they are in turmoil over the 5 percent, but I'm not sure how they will testify if they are going to testify on the 5 percent.

Also, next week we will have the Commissioner of the IRS, Margaret Richardson, and we're going to have Nat—I think it's Gandhi, the Director of Tax Policy for the GAO; and have them address some of the issues on compliance, but I'm very anxious to hear from them.

If there are particular things that all of you would like to hear from them publicly, too, please submit it to myself, or Mr. Kennedy, or any member, because we're trying to sort out these unresolved questions with them.

They have told me that they are trying to work on compliance, and trying to find an easier way for people to comply. My experience does not meet those words. With that, I want to thank the three of you again for your patience, and all the work you're doing with this subcommittee.

[Whereupon, at 1 p.m., the subcommittee was adjourned, subject to the call of the chair.]

APPENDIX

Opening Statement
of
Chairman Linda Smith

Subcommittee on Taxation and Finance
Committee on Small Business

"Clarifying the Status of
Independent Contractors"

July 26, 1995
10:00 a.m.

Good morning. It is a great pleasure to welcome our witnesses and guests here today. We now begin a hearing on the top priority issue of small businesses across America: clarifying the status of independent contractors. This hearing will continue on Wednesday, August 2, 1995, at 2:00 p.m., to seek the position and recommendations of the U.S. Treasury Department's Internal Revenue Service, among others, on resolving this long-standing problem.

As most of you know, this Subcommittee has dedicated its efforts to examining alternatives to reducing the enormous

tax revenue and compliance burdens small businesses now face. As they drive our Nation's economy, small businesses find tax impediments most stifling to their growth and success.

Not surprisingly, five of the top ten recommendations from the delegates to last month's White House Conference on Small Business are tax recommendations. The top recommendation of the delegates is the need to provide a clear, objective definition or standard for independent contractors. This Congress can and should provide one.

In large part, the debate surrounding the classification of workers has not been solved to date, not because there is "no easy solution" -- sensible solutions are seldom "easy" -- but because of narrow and outdated underlying policy choices which plague the entire federal tax system.

Changing the prerogatives under new, distinct independent contractor criteria should include a broader, more realistic understanding of the information and entrepreneurial dynamics of today's business world.

We should be looking to reduce, not expand the burden of compliance on American businesses -- and to create

incentives for the self-employed to maximize their productivity and personal responsibility.

At the same time, ensuring tax compliance and protecting revenue are very important objectives. But to protect revenue we do not have to disregard our fundamental goals of reducing the size and scope of the federal government -- and of relieving hard-working and honest taxpayers from onerous tax burdens.

Too often, overzealous and unfair enforcement procedures -- spurred largely by a reluctant bias against independent contractors -- continues to cloud a resolution.

Allowing harsh and inconsistent enforcement hurts American businesses. It results in the imposition of large back taxes and severe penalties on small entrepreneurs who are trying to comply with the law -- increasing their burden and putting some of them out of business.

Accordingly, this hearing will review the legislative proposal of Representative Jon Christensen (R-Neb.), H.R. 1972, the "Independent Contractor Tax Simplification Act of 1995." In response to the top priority of the small business delegates, Mr. Christensen introduced H.R. 1972 on June 30,

1995, with 100 original co-sponsors. I am one of those original co-sponsors, and I am delighted to welcome Mr. Christensen here to discuss his legislation which has gained much momentum in a very short period of time.

I am equally pleased to welcome Representative Jay Kim (R-Cal.) to discuss his proposal, H.R. 582, the "Independent Contractor Tax Fairness Act of 1995," which is also designed to provide clearer, more objective criteria to determine who is not an employee. I am also co-sponsoring Mr. Kim's bill.

Briefly, though, before we begin, I would like to share with you the concerns of a constituent of mine, Donald Gene Wade of Toledo, Washington. Mr. Wade is an independent contractor affiliated with H.D. Vest Financial Services. He markets financial and insurance products for H.D. Vest out of his own existing and well-established business and client base.

In his testimony, Mr. Wade stresses that he has chosen to be an independent contractor as opposed to an employee. This relationship maximizing his business success and opportunities, and apparently those of H.D. Vest. It is a win-win situation for both parties.

This should also be a winning situation for the IRS because the IRS is getting its revenue from these taxpayers in full compliance with the law. But, instead, the IRS is attempting to target Mr. Wade and thousands of independent contractors like him in his industry for reclassification as employees.

This action threatened by the IRS in Mr. Wade's case begins to illustrate to me the need for a clearer, more objective definition that will make it easier for employers and the IRS to distinguish between an independent contractor and an employee.

And, it clearly indicates just how right the delegates to the 1995 White House Conference on Small Business are in voting this their top legislative priority. Let's work together to make it one of ours.

Statement of Congressman John E. Baldacci
Small Business Subcommittee on Tax and Finance
Hearing on Status of Independent Contractors
July 26, 1995

Madame Chairman, I welcome the opportunity to hear the testimony today and in our second hearing on the status of independent contractors. This has long been a bone of contention in the small business community and it is obvious that some clarification of the way in which independent contractors are classified is in order.

The lack of criteria in the 20 point test the Internal Revenue Service applies to businesses in an effort to determine exactly who is an employee and who is an independent contractor are largely subjective. As a result, businesses have often been treated in an inconsistent and inequitable manner. I'm sure many of my colleagues on the Committee have heard from exasperated small businesspeople in their districts about the ongoing fued they've had with the IRS about misclassified employees. It's no wonder our constituents are exasperated. Under similar circumstances, one business could be required to reclassify an employee while another business would be left alone.

Having said that, we should not lay the entire blame at the door of the IRS. The IRS is charged with enforcing our tax laws, and history shows that the independent contractor sector has not always been at the top of the compliance list. Congress has been very slow to address what has been an ongoing problem for years. In addition, a number of employers have been relatively lax in filling out their IRS Form 1099 information return.

We now have an opportunity to address this problem. The White House Conference on Small Business has made some very useful recommendations on this matter, and I am hopeful that Congress can make the necessary changes to clarify the status of independent contractors.

Again, I look forward to hearing the recommendations our witnesses have to offer.

Testimony of Representative Jon Christensen
Before the Subcommittee on Taxation and Finance
of the
Committee on Small Business
July 26, 1995

Madam Chairman, I want to thank you and the other members of the Subcommittee for this opportunity to testify on the importance of clarifying federal tax provisions with respect to independent contractors.

"THE IRS WAGES WAR ON THE SELF-EMPLOYED." "REBUFFING IRS ATTACKS ON WORKERS." "REVENGE OF THE TAX MAN." The headlines go on and on. These are recent articles about how the Internal Revenue Service has used murky, subjective criteria to target honest, self-employed entrepreneurs and reclassify them as employees.

Let me lay out some background on this pervasive problem. Although in today's high-tech world there are many working relationships between businesses and individuals, the Internal Revenue Code classifies all such relationships into just two categories: Either you are an "employee" or an "independent contractor."

Some workers are categorized by law as one or the other. Other workers may be classified as independent contractors, with a reasonable amount of certainty, under the safe harbors enacted in Section 530 of the Internal Revenue Code. Those not fortunate enough to fall under these two classes are carefully scrutinized under the IRS' infamous 20-factor test derived from common law.

What does it matter whether someone is an "employee" or an "independent contractor"? This distinction is important because it determines whether the payor or the payee is responsible for withholding income tax and the payment of FICA and FUTA taxes. In other words, it has little to do with *how much* tax gets paid, but everything to do with *who pays.*

Almost everyone will agree that the 20-factor test is unclear and far too subjective. It is quite possible to take two seemingly identical situations and find employee status in

one and independent contractor status in another. Nevertheless, in recent years the IRS has bludgeoned small businesses over the head with the 20-factor test, targeting truckers, florists, travel agents, computer programmers, even ministers. According to one recent estimate, the IRS' war on our nation's job creators has resulted in the reclassification of 439,000 independent contractors and the collection of $678 million in fines and taxes since the mid-1980s.

The IRS's actions have been especially deadly to small businesspeople. Unlike their Fortune 500 counterparts, our nation's small businesses cannot afford the fancy tax lawyers and litigators needed to defend themselves against IRS legal hit squads. Consequently, rather than fighting the IRS and its use of the murky 20-factor test, many entrepreneurs are forced to close their doors, putting countless industrious Americans out of work.

America's small businesspeople have finally said enough is enough. Last month, the White House Conference on Small Business convened in Washington to debate a whole host of issues important to our nation's entrepreneurs. The top vote-getter at the Conference was a proposal to clarify the standards for determining whether an individual is an employee or independent contractor. Specifically, the delegates recommended that Congress "should recognize the legitimacy of an independent contractor," stating further that the current common law twenty-factor test is "too subjective." The Conference delegates called upon Congress to establish "realistic and consistent guidelines."

Those on the front lines have spoken and we've listened. On June 30th, just two weeks after the Small Business Conference, I and 100 original cosponsors introduced H.R. 1972, The Independent Contractor Tax Simplification Act of 1995. Unlike past attempts to resolve this issue, H.R. 1972 defines who is <u>not</u> an employee. It establishes distinct, clear and objective criteria for those seeking to perform services as an independent contractor. These new criteria may only be used if the independent contractor and the

business for whom the services are being performed correctly comply with income reporting rules.

Specifically, H.R. 1972 establishes a three-part objective test for determining whether someone is not an employee. To qualify as an independent contractor, you must meet all three parts. Two of the parts contain subparts, but you must only meet one to satisfy that part. Let me go through the criteria briefly.

Part One: Investment. Does the individual: (1) have a significant investment in training or assets; or (2) incur significant unreimbursed expenses; or (3) agree to work for a specific time or complete a specific result, and is liable for damages for failure to perform; or (4) receive compensation primarily on a commission basis; or (5) purchase a product for resale? If the individual satisfies any one of these subtests, then Part One is met.

Part Two: Independence. Can the individual demonstrate *just one* of the following subparts: The individual (1) has a principal place of business; or (2) does not primarily provide the service in the service recipient's place of business; or (3) pays a fair market rent for use of the service recipient's place of business; or (4) is not required to perform service exclusively for the service recipient and (a) has performed a significant amount of service for others; or (b) has offered to perform service for others through advertising, individual written or oral solicitations, listing with agencies, brokers, or others; or (c) provides service under a registered business or trade name. Meet any one of these four subtests and you satisfy Part Two.

Part Three: A Contract. Is there a written agreement between the parties? This helps clarify each parties responsibility for the payment of taxes thereby aiding compliance.

That's it. Meet all three parts -- independence, investment, and contract -- and you qualify as an independent contractor. But remember the independent contractor and the business for whom the services are being performed must correctly comply with income reporting rules. If they fail to do so, then they are left with the burdensome 20-factor test and all of its traps.

It is important to note that my bill does not eliminate the 20-factor test nor the safe harbors under Section 530. It simply provides for an alternate test that can be used if you comply with all income reporting requirements.

As a matter of public policy our tax laws should not favor employee status over independent contractor status, or vice-versa. Individuals should be free to enter into business arrangements of their own choosing without the IRS pushing them into one category or the other. Despite a well-documented record of discouraging independent contractor status, the IRS is now on record that it will not discriminate against independent contractors. Margaret Richardson, Commissioner of the Internal Revenue Service, told delegates to the White House Conference on Small Business that the IRS "does not care whether someone is an employee or an independent contractor as long as they properly report their income." H.R. 1972 clearly satisfies her reasonable request and I look forward to working with Mrs. Richardson on this important issue.

In closing, I want to again thank you, Madam Chairman, and my colleagues on the Subcommittee for the opportunity to testify before you today. We are in a changing world. No longer will the majority of Americans earn a living in the fields and factories that many of us and our ancestors toiled in. Rather, we are at the brink of the Third Wave Information Age Speaker Gingrich has so vividly described. This new era will feature new types of employment relationships, where people can work out of their homes and "telecommute," where individuals can service thousands of customers all over the world through the push of a button. It will foster the entrepreneurial spirit that has made this country great. This new era has the potential of bringing enormous improvement to the lives of all Americans. Our laws should encourage, not hinder, this development. That's precisely why we need to adopt a new, clear, objective standard for determining who is self-employed and who is not -- a standard based on freedom and which allows those who wish to benefit from this new era to do so.

Thank you.

SOCIETY OF AMERICAN FLORISTS

STATEMENT BEFORE THE COMMITTEE ON SMALL BUSINESS

SUBCOMMITTEE ON TAX AND FINANCE

UNITED STATES HOUSE OF REPRESENTATIVES

submitted by

FERN DENHOLM

owner

FLOWERS 'N FERNS
BURKE, VIRGINIA

on behalf of the

SOCIETY OF AMERICAN FLORISTS

JULY 26, 1995

Madame Chair and Members of the Subcommittee, I am Fern Denholm testifying on behalf of the Society of American Florists (SAF). The Society of American Florists is the only national trade association representing the interests of the entire floral industry. Our membership includes more than 20,000 small businesses nationwide: growers, wholesalers and retailers, suppliers, educators and affiliated organizations.

In addition to being a member of SAF, I am owner of Flowers 'n Ferns, a retail flower shop in Burke, Virginia and a delegate to the 1995 White House Conference on Small Business.

I greatly appreciate the opportunity to appear before the Subcommittee to discuss the implications of the definition of the independent contractor on small businesses.

I would like to talk about three items today:

1. The White House Conference on Small Business and the intent of the language drafted by the delegates.

2. The impact of IRS guidelines and enforcement on businesses.

3. My own personal experience regarding the effect of the current guidelines and my ability to expand my business.

1. The White House Conference on Small Business and the intent of the language drafted by the delegates.

As a delegate to the White House Conference on Small Business, I was one of 1,700 small business owners who voted to make the definition of the independent contractor the top legislative priority.

The following statement is included in the final White House Conference recommendations and I quote:

"The definition of an independent contractor must be clarified. Congress should recognize the legitimacy of the independent contractor.

a) The 20 factor test is too subjective. The number of relevant factors should be narrowed with more definition guidelines for implementation. Realistic and consistent guidelines which require one of four criteria plus a written agreement. The criteria are (1) realization of a profit or loss; (2) separate principle place of business; (3) making services available to the general public; or (4) paid on a commission basis.

b) Safe harbor provisions should be established which would protect the hiring business from the burdensome penalties currently being assessed by the IRS. De minimis rules based on dollars paid, hours worked, years in business, and/or specified close end projects should be established.

c) The IRS should eliminate back taxes for misclassifications when 1099 forms are filed and there is no evidence of fraud.

d) Congress should specifically allow employers and independent contractors to provide joint technical training and to jointly utilize major specialized tools without jeopardy of reclassification of the independent contractor to employee status.

e) Changes and implementation processes should be formulated by a joint committee of legislators and small business people."

The above statement received the highest number of votes 1,471, making it the number one priority of the conference delegates.

2. The impact of IRS guidelines and enforcement on businesses.

The impact of the current regulations has made it extremely complicated for my industry to hire independent contractors. For example: In retail floral shops it is customary to hire contract designers during peak times of the year, such as at Valentines Day or during the wedding season. One of the guideline questions asked by the IRS is: "Does the independent contractor own his own tools?" In our industry most designers own their own knives. But as a rule, the shop owner provides scissors, wire cutters and pick machines. Therefore, the rule is not specific enough for me to understand if a contract designer could use daily tools provided by the contracting shop and necessary to make an average floral arrangement or if, as an independent contractor, he must provide and use all of his own tools.

Results of an SAF survey show that it is common for employers in all segments of the floral industry to use independent contractors on a regular basis. Workers hired on a contract basis typically perform tasks such as piece-work planting or design and driving.

Several years ago, a greenhouse owner hired workers from a cement contracting company to pour concrete at a greenhouse. The IRS fined the greenhouse owner because he had not claimed these workers as employees, although the individuals performed similar tasks contractually for other businesses.

It is virtually impossible for the small business owner to employ every type of laborer needed to maintain the business. From construction workers to electricians to designers the small business owner depends on being able to hire independent contractors on an as needed basis.

IRS reclassification of an independent contractor as an employee has a drastic affect on the employer. Payment of back taxes, penalties and interest in additional to providing that person with benefits such as healthcare and paid leave can force a small business to shut its doors.

3. My own personal experience regarding the effect of the current guidelines and my ability to expand my business.

If you have ever called your florist during a holiday and they have said, "I'm sorry, we can't fill that order for you," your reaction has probably been, "Why don't they just hire more designers and drivers?" We would be thrilled to be able to do this, but because of regulatory restrictions and complicated and confusing guidelines associated with hiring an independent contractor, many retail florists have chosen to turn business away instead of dickering with the IRS.

In fact, I have avoided hiring independent contractors. This business decision has kept us from expanding some of our services, such as wedding coordination and plant care, into full fledged business services. A few years ago, I was maintaining plants in a large bank. It took two employees an average of three hours, twice a week for the care and maintenance of the plants.

At the time, I was looking into expanding this service. Unfortunately I became seriously ill, which required the employees who had previously been handling the plant maintenance to remain in the shop. We considered hiring an independent contractor to take over while I recovered, but the definition of independent contractors was so complicated and contradictory, we opted to terminate this portion of our business rather than expand it as we had originally hoped.

Instead of hiring independent contractors as drivers, we have joined a cooperative delivery service, here in the Washington metropolitan area, to cover a larger delivery area. At times, however, we have been forced to use costly, courier service. Like other florists across the country, there have been occasions when we have not been able to keep up with demand. Had we been comfortable with hiring independent contractors as designers and drivers we would have been able to fill your flower order and you would have been able to express your feelings with a beautiful, floral gift.

The independent contractor is a vital component of the small business community. Not only do independent contractors allow the small business owner to keep up with workplace demands, but it allows fledging businesspeople the opportunity to build the basis for a company through independent contractor service.

In closing, I would like to thank Representative Jon Christensen and the other 100 original co-sponsors of H.R. 1972, the Independent Contractor Tax Simplification Act of 1995, for addressing this important issue. The 104th Congress, and specifically this Committee, has been very receptive to the concerns of small businesses and main street America. Thank you for taking the time to hold these hearings.

National Association for the Self-Employed
Headquarters • 1023-15th St., NW • Suite 1200 • Washington, DC 20005-2600 • 202-466-2100 • 202-466-2123 (fax)

TESTIMONY OF

BENSON S. GOLDSTEIN

LEGISLATIVE AND TAX COUNSEL

THE NATIONAL ASSOCIATION FOR THE SELF-EMPLOYED

BEFORE THE

SUBCOMMITTEE ON TAXATION AND FINANCE

COMMITTEE ON SMALL BUSINESS

U.S. HOUSE OF REPRESENTATIVES

ON

INDEPENDENT CONTRACTOR REFORM

JULY 26, 1995

On behalf of the National Association for the Self-Employed, I appreciate the opportunity to testify before the House Small Business Subcommittee on Taxation and Finance. My name is Benson S. Goldstein, the NASE's Legislative and Tax Counsel; and I am pleased to testify today on the issue of independent contractors.

Of the 320,000 small business members of the NASE, 88 percent of our members have 5 or fewer employees. Many of our members consider themselves to be independent contractors or persons who utilize the skills of independent contractors on a regular basis. It is for this reason that the NASE commends Chairman Linda Smith and the other Subcommittee members for holding this very important hearing on a topic of major concern to the small business community.

The NASE believes today's Subcommittee hearing is very timely. This hearing is critical in terms of setting the stage for a thorough review by Congress of the importance of independent contractors to the U.S. economy of the nineteen nineties.

The NASE is strongly supportive of H.R. 1972, the Independent Contractor Tax Simplification Act of 1995, introduced by Representative Jon Christensen and 13 other House Ways and Means Committee members. H.R. 1972 has approximately 100 original House cosponsors overall. In addition, the NASE commends Representative Jay Kim for the introduction of H.R. 582, the Independent Contractor Tax Fairness Act of 1995. The strong support in Congress for independent contractor reform legislation mirrors the fact that the nearly 2,000 delegates to the June 1995 White House Conference on Small Business made clarification of independent contractor status the number 1 issue of the conference.

Small Business Supports Clarification of Independent Contractor Status

The small business community has long supported clarification of independent contractor status. This support has been largely fueled by the vigorousness and intensity of IRS payroll tax audits over the years, which have focussed on employment classification issues. Unfortunately, these audits have been used by the IRS to reclassify individuals who ordinarily consider themselves to be independent contractors as employees, thereby stifling entrepreneurship and risktaking.

In beginning its independent contractor investigation today, the Subcommittee's analysis of the issue should be based on a policy objective of trying to accommodate changes in the U.S. and global economies toward more -- not less -- flexibility in employment and contracting arrangements. Today, more than ever, as large companies downsize, more and more people are reentering the work force by putting their name on a "shingle" and going into business for themselves -- many as independent contractors.

To make decisions on employment classifications, the IRS uses a list of 20 questions, derived from common law precedents dating back to the Magna Carta era, relating to the relationship between an employer and a contractor/employee. This 20-factor test centers around an analysis of the degree to which a service recipient has control over a worker and the services provided by that worker.

Not only is this 20-factor test antiquated, but the NASE and others in the small business community agree with the Treasury Department when it calls this 20-factor test subjective. In testimony before the House Government Operations Committee in 1993, Treasury Deputy Benefits Tax Counsel J. Mark Iwry stated that the 20-factor test has been

"criticized as leading to imprecise and unpredictable results..."[1]

We understand that in the vast majority of audit cases, the IRS has reclassified the independent contractor as an employee. This scenario typically causes the business who hired the independent contractor to face costly fines and penalties. This results in a negative "domino effect" on small business:

1.) First, the businesses that utilize independent contractors to perform short-term projects or provide consulting expertise become leery of utilizing independent contractors.

2.) Second, this then has a direct impact on the independent contractors themselves who see businesses shying away from their services because of the fear of being audited.

Section 530 of the 1978 Revenue Act

Section 530 of the Revenue Act of 1978 was the last time Congress passed broad legislation addressing the issue of who is an independent contractor and who is an employee. Although Section 530 clearly has flaws, it does provide employers with a safe harbor for determining who is an independent contractor. The statute also imposes a moratorium on any IRS regulations involving independent contractor status.

This existing law provides employers with relief from potential IRS reclassification of a firm's independent contractors as employees by prohibiting the IRS from reclassifying such workers if the employer has a reasonable basis for it treatment of the workers as independent

---

[1]Mr. J. Mark Iwry, Deputy Benefits Tax Counsel, Department of the Treasury before the Subcommittee on Commerce, Consumer Affairs, Committee on Government Operations, U.S. House of Representatives, June 8, 1993, page 1.

contractors. A reasonable basis includes reliance on (1) judicial precedent or IRS rulings, (2) a past IRS audit in which there was no assessment attributable to employment taxes, and (3) a long-standing industry practice in treating the workers as independent contractors.

The NASE recognizes that improvements can be made to Section 530 -- but our definition of improvements in the law are likely to be the direct opposite of the IRS' view. The IRS wants Section 530 repealed, including elimination of the provision which prohibits the agency from issuing regulations on independent contractor status.

Any improvements made to Section 530 should be based on the premise of fostering the nation's entrepreneurial base -- and not look for ways to impede the availability of independent contractor status. In the absence of clear and unambiguous safeguards built into any new independent contractor law, should Congress provide the IRS with broad authority to issue regulations -- we believe that such a grant of authority could be equivalent to "putting the fox in charge of the hen house."

H.R. 1972 and H.R. 582 are positive initiatives for small business in general and independent contractors in specific. Both bills strike a positive balance between the needs of the small business community, the nation's economy, and the tax administration process -- and the bills accomplish this without providing the IRS with carte-blanche authority to issue independent contractor regulations.

Independent Contractor Status and the Federal Budget

IRS Commissioner Margaret Richardson has made speeches recently that the U.S. Treasury loses over $2 billion yearly on "misclassification" of workers as independent contractors. The NASE strongly disputes these estimates. In fact, we believe that bills like

H.R. 1972 and H.R. 582 will prove to be pro-growth and are likely to create jobs for hundreds of thousands of Americans. Over the long-term, pro-growth independent contractor legislation should increase federal revenues -- as opposed to losing revenues.

Treasury Department testimony from recent years actually backs up the NASE's contentions on the issue of federal revenues. In his 1993 testimony before the House Government Operations Committee, Treasury Department Deputy Benefits Tax Counsel J. Mark Iwry provided a lengthy discussion about worker misclassification.[2] Iwry stated that "Deliberate misclassification...may tend to result in net revenue losses to the extent misclassification is undertaken to obtain a net tax benefit for the employer and the worker."

The NASE does not and will never condone deliberate misclassification of workers. We do not believe Congress should condone such activity. But if Congress is primarily concerned about short-term budgetary impacts resulting from what Treasury calls worker misclassification, then the nation's legislative body should rest easier. Iwry further stated in his 1993 testimony that "it is impossible to determine a priori whether misclassification tends, on average, to result in a net revenue gain or loss."

Iwry noted a very significant reason for his revenue impact analysis. He stated "current Federal tax law does not consistently favor status as either an employee or an independent contractor." In other words, workers end up paying about the same taxes either way. Independent contractor reform legislation can and should be enacted into law -- without fear that the measure will turn out to be nothing more than a raid on the federal budget.

---

[2]Ibid, page 6.

Conclusion

In conclusion, the NASE supports enactment of independent contractor reform legislation. Such legislation should be based on the notion of promoting entrepreneurship and fostering independent contractor status -- as opposed to placing restrictions on the use of independent contractors. Thank you for the opportunity to provide our thoughts on this very important topic to the small business community.

DEBBI-JO HORTON
Accountant

225 Waterman Avenue
P.O. Box 14198
East Providence, Rhode Island 02914

(401) 435-4988
Fax (401) 434-9203

Congress of the United States
House of Representatives
Committee on Small Business
Subcommittee on Taxation and Finance
B-363 Rayburn House Office Building
Washington, DC 20515

Madam Chair and members of the Committee,

My name is Debbi-Jo Horton I am an Appointed Delegate to the Rhode Island Delegation of the 1995 White House Conference on Small Business as their Taxation Chair and the Elected New England Regional Taxation Chair for the implementation team, as well as the owner of a small business located in East Providence, Rhode Island I have been in business for 6 years during which I have worked closely with my clients on the issue of employee vs. independent contractor I hold a Bachelor of Science in Administration with a major in Accounting from Bryant College and am working towards my certification as a CPA

I commend this Committee for giving the issue of the Independent Contractor such timely consideration According to the 1995 White House Conference on Small Business it is the most important issue plaguing small businesses today

Many of the Delegates to the White House Conference on Small Business participated in long hard debate about the specific wording of the National Conference Recommendation Agenda (NCRA) #224 that was amended and passed as the #1 issue of the 1995 White House Conference on Small Business Through the generosity of America Online, delegates from across the country communicated their views, debated them and refined the wording of recommendations that would represent the majority of all small business owners. Amendments were debated even during the Conference itself and the final version is as follows:

224. The definition of an independent contractor must be clarified Congress should recognize the legitimacy of an independent contractor.

a) The 20 factor test is too subjective. The number of relevant factors should be narrowed with more definition guidelines for implementation Realistic and consistent guidelines which require one of four criteria plus a written agreement. The criteria are (1)

realization of profit or loss; (2) separate principle place of business, (3) making services available to the general public; or (4) paid on a commission basis

b) Safe harbor provisions should be established which would protect the hiring business from the burdensome penalties currently being assessed by the IRS De Minimis rules based on dollars paid, hours worked, years in business, and/or specified closed end projects should be established

c) The IRS should eliminate back taxes for misclassification when Form 1099's are filed and there is no evidence of fraud

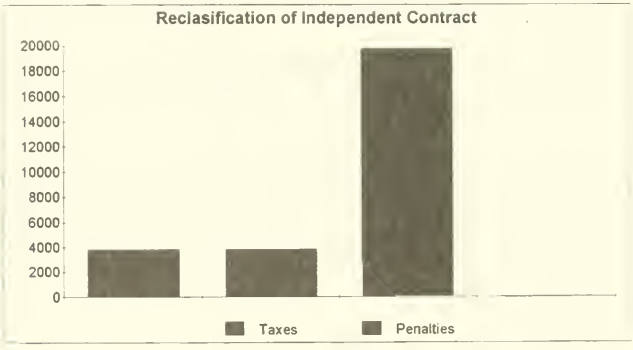
d) Congress should specifically allow employers and independent contractors to provide joint technical training and to jointly utilize major specialized tools without jeopardy of reclassification of the independent contractor to employee status

e) Changes and implementation processes should be formulated by a joint committee of legislators and small business people

This recommendation received 1471 votes

Many small businesses are either independent contractors or users of the services of independent contractors. Frequently they are both For instance, I am an independent contractor to the clients I service and I use independent contractors for brokering assets, marketing advice, or computer work. I do not possess the knowledge to service my clients properly in those areas, nor is it reasonable for me to hire these people as an employee.

The subjectivity of the IRS's 20 factor test can bankrupt a small business. The ramifications of the reclassification of an independent contractor to employee status is costly and often the reclassification unfair and unreasonable The worst case scenario in regards to taxes due, penalty and interest can be best seen in this graph



This graph is based on an independent contractor with a $50,000 contract that has been reclassified as an employee with the IRS determining intentional misclassification. The ramification would be 100% of employer's FICA & Medicare and 100% of employee's FICA & Medicare; 100% of the income taxes that would have been withheld assuming the contractor was single with one exemption.

Then because of the determination that the misclassification was intentional, and this does not have to be proven by the IRS, the penalty would be 100% of the tax. In addition they could assess penalties for failure to file employment forms, make timely deposits, accuracy-related penalty for negligence or substantial understatement of taxes, penalty for civil fraud, and even aiding and abetting the understatement of tax liability.

Then there is interest which is currently 7%. This would apply to all open years. Personal liability exists for "trust fund" portions of these taxes and 100% penalty for failure to file cannot be discharged in bankruptcy.

And this is only the beginning...reclassification can effect qualified pension plans and other benefit plans because all of the nondiscrimination tests must be refigured.

An example of this is what happened to a Smithfield, RI company. They were contacted by an IRS Agent and asked if he could stop by to discuss the issue of employee vs. independent contractor with them. They were assured that this was not an audit it was an informative interview only.

They cooperated and were very forthcoming in their interview with the agent. Shortly after completion of the interview, they were again contacted and informed that a payroll and subcontractor audit would be conducted.

The IRS reclassified ALL subcontractors as employees for the years 1986-1988 and assessed penalty, interest and all portions of payroll taxes for both employer and employee. They were assessed a total of $72,000 and told that a certified check must be delivered within 24 hours or a one and one half times penalty would be assessed bringing the total to $108,000.

The company hired legal council and spent the next two years fighting the assessment incurring $10,000 in attorney fees. The IRS settled for $38,000 and affidavits signed by each independent contractor certifying that they had paid their self-employment taxes. If it hadn't been for their family and friends they would have had to close the doors. The settlement amount was paid.

But, it didn't end there. The IRS still kept placing liens on their property even though the settlement had been made. It took an additional 6 months to straighten it out at which time they received a hand-written note of apology for the inconvenience.

The Independent Contractor issue is a major concern for many small businesses. While it may appear that individuals are serving as employees of a small business in fact they are not.

The duration of employment under contract may very well be an issue for the Internal Revenue Service, however, there is a severe misunderstanding of the overall status of this individual.

A good case in point would be a Repertory Theater. Many of the actors consider themselves independent contractors and in fact they are. While they may be employed by a particular theater for a duration of time, the fact is that they are also marketing their skills and abilities to many others.

An actor is responsible for auditioning for parts in a play. Inasmuch, they may be successful in obtaining parts in a series of plays over an extended period of time with the same theater. However, the individual still serves as an independent contractor and not an employee. The guaranteed employment is not present at anytime and their ability to provide services to others at the same time is still present.

Similar arguments could be made for nurses that serve as independent contractors. Self employment and the ability to market their services to others provides them with the flexibility to serve numerous clients. This is very important to them as small business persons. The mere fact that they may serve the same company for multiple patients does not constitute the presence of permanent employment status.

A large number of independent contractors are self-employed with no financial means to educate themselves or their employee(s) with technical training. They can often obtain this training through a client with joint training sessions. To the client this would make sense, because if you change part of your system or procedure then it only makes sense to train ALL the people who use it, including independent contractors.

I have reviewed the contents of H.R. 1972 and H.R. 582 and they both provide a good foundation for change, but both fall a little short of the legislation we need to resolve the independent contractor debate. Of the two bills H.R 1972 is closer to the needed wording to recognize the legitimacy of the independent contractor and clarify the Internal Revenue Code as it currently stands. This bill is more current and has the support of the Sponsor of H.R. 582 and many of H.R. 582's Cosponsors.

H.R. 1972 does not, however, repeal the 20 factor test that is in the current Code. It is essential to repeal Section 530 as it refers to the 20 factor test and codify the revisions of the final version of the bill. The Taxation Implementation team from the 10 regions would be willing to be part of a joint task force of legislators and small business people to negotiate the needed changes to this bill and justify the points made in the Delegates' Independent Contractor Recommendation.

The American Institute of Certified Public Accountants (AICPA) have come forward with a safe harbor recommendation that would guarantee independent contractor treatment of a worker. The delegates to the White House Conference on Small Business discussed elements of the AICPA position at the Conference and have continued this debate as it relates to our top issue recommendation.

Essentially, the AICPA position provides for a iron clad safe harbor. If the employer withholds 5% of the subcontractor's gross revenue, remits the withholding to the IRS with appropriate 1099 filings, and there is a written agreement, then, an independent contractor arrangement exists and the IRS can not reclassify. This is, in my view, an employer based provision and could potentially change the relationships between employer and employee.

The safe harbor provision as set forth by the AICPA is not concerned with the merits of the employment relationship at all. The employer can secure independent contractor treatment on any newly hired worker as long as the 5% withholding is implemented and a written agreement executed. The regional taxation chairs of the WHCSB have discussed this and concur this would not only support the current trend of large corporate downsizing, but encourage small business owners to engage in independent contractor arrangements when ever attainable. Proponents contend the market place will self-monitor the relationships and not allow for a shift from employee status to independent contractor. We contend if an employer can secure independent contractor status in lieu of employee status with an iron clad safe harbor, they will do so. The employer will no longer have to match social security and Medicare liabilities, fund employee benefits and profit sharing, pay for unemployment insurance, vacations, holidays and sick pay, or be subject to Department of Labor rules, and family leave legislation. We contend the employee will often accept these conditions in exchange for employment due to the tight job market and competition for employment.

If in fact this is a result of the AICPA safe harbor, the shift in employment relationships will produce many more 1099 filings with the 5% withholding and reduce the number of W-2 filings. This could actually decrease the number of withholdings remitted to the IRS on a monthly basis since the employee withholdings are much higher than 5%, and potentially require even more collection efforts on the part of the IRS.

The White House Conference Delegates discussed a 5% withholding option and determined this was not practical nor viable. Small business is overwhelmed with compliance regulations and paperwork as is. Additional compliance in the form of subcontractor withholdings will create an undue burden.

In addition, 5% of withholding could represent some small businesses entire net income or an amount well above the total taxes due. I have provided information from an actual subcontractor's 1993 and 1994 schedule C to document this. The taxpayer is a self-employed carpenter, married, with two children and a non-working spouse. His self-

employed income is the sole source of their support. The effects of a 5% withholding would be as follows:

	1993	1994
Gross revenue from self-employment	$160,213	$184,053
5% withholding by employer	8,011	9,203
Net income from self-employment	18,836	18,860
Percentage of withholding on net income from self-employment	42.53%	48.80%
Actual tax liability net of Earned Income Credit	$1,708	$1,689

As indicated, in industries with high cost of goods sold and small margins, the 5% withholding could prevent the self-employed business from continuing and/or providing for their families. This provision also creates a hardship on new start up businesses who often operate at a loss the initial year of operation.

The safe harbor provision as presented by the AICPA is form over substance pure and simple. In the event the safe harbor is not obtained, the 20 common law factor test applies.

The White House Conference on Small Business delegates represent the concerns of both the employer and the worker. The burden cannot be passed on to the small businesses to make the independent contractor comply with filing his/her schedule C and paying his/her share of taxes. Most small businesses do comply with the reporting requirements for their independent contractors. Burdening them with withholding requirements would not promote additional compliance. In fact it could very well reduce the amount of compliance. For example, if the contractor refuses to work for the service user if there is withholdings and the service user needs to use this particular contractor, the user will not withhold. Fearing a RED FLAG ALERT by filing a 1099 with no withholdings, the user will not file the 1099 and the IRS will then have no way to determine compliance by the independent contractor.

I am very appreciative of this Committee and the 104th Congress for making it a priority to streamline regulations. It is my opinion and that of 1,471 delegates that the independent contractor rules are the perfect place to begin.

I thank Madam Chair and this Committee for giving me the opportunity to testify on Wednesday, July 26, 1995 and I welcome any questions you may have at this time.

TESTIMONY OF PAUL JOHNSON
P.J. NICE CONSTRUCTION

ON BEHALF OF
ASSOCIATED BUILDERS AND CONTRACTORS

BEFORE THE
HOUSE SMALL BUSINESS COMMITTEE
SUBCOMMITTEE ON TAX AND FINANCE

JULY 26, 1995

Good morning Madam Chairman and honorable members of the Subcommittee. My name is Paul Johnson, and I am the owner of P.J. Nice Construction, located in Maryland. I appreciate the opportunity to appear before you today to discuss the simplification of the independent contractor designation. This issue is extremely important to the open shop construction industry, and I am pleased to speak on behalf of Associated Builders and Contractors as well as my own company.

Associated Builders and Contractors is a national trade association representing approximately 18,000 contractors and related firms in 81 chapters across the country. ABC's diverse membership is bound by a shared commitment to the free enterprise system and the merit shop philosophy of awarding construction contracts to the lowest responsible bidder, through open and competitive bidding. With 80 percent of the construction workforce choosing to work open shop, it is an honor to be their voice before you today.

In the small business world and in construction in general, independent contractors are

often the perfect answer to a pressing need for special skills and know how for certain projects. The flexibility provided by an independent contractors provides numerous advantages for the business owner as well as for the independent contractor. It is imperative that businesses be able to make sound economic decisions about the classification of individuals as employees or independent contractors.

Because of the importance of independent contractors to the construction industry, clarification of the standards that determine independent contractor status is critical. The current 20-factor, common law test is unwieldy. Because of the uncertainties surrounding it, it can lead to litigation and potentially to back tax penalties that can be devastating. Not only are the financial implications very serious for a small business like mine, but it is also very upsetting to discover that a sound business decision made in good faith one day, is a costly violation of the law the next day.

Independent contractors in the construction industry make significant investments in their own businesses. These investments include tools of the trade, vehicles, consumables, and specialized equipment. But the most important, and often most costly investment made by independent contractors in the construction industry is insurance. In order for an independent contractor to do business with my firm, they must demonstrate that they have sufficient insurance coverage. Other investments may included travel from job to job as well as any special clothing or personal protective equipment. Finally, independent contractors in certain crafts must have earned certificates pre-qualifying them to work with certain materials or to certain standards.

The nature of construction contracting necessitates commitments from independent contractors to complete certain tasks within certain time periods. The only way a general contractor, such as myself, can estimate a job accurately for time and cost is to make sure that all independent contractors I contract with have an acute awareness of their schedules and the overall time line of the project. The contracts that I use for my independent contractors make them liable for early termination. In cases where the contracts are task, rather than time, oriented, the independent contractor would be liable for damages for defective work.

The independent contractors I contract with also contract with other general contractors. Understandably, construction work cannot be simultaneously performed at more than one site. However, it the nature of a project that tasks must be performed in a certain order, leaving down time between independent contractor performances. Independent contractors often take advantage of these intervals to perform services for others. This is an ideal situation for all involved.

Despite these factors, which so clearly indicate proper designation of independent contractor status, the construction industry is repeatedly plagued by IRS audits and reclassifications. The IRS generally examines worker classification some time after the taxpayer has made its determination of the worker's classification and after the taxpayer has filed its returns. Thus, reclassification by the IRS can result in severe penalties. Because the current system is unwieldy and unpredictable for the contractors involved, the ideal solution seems to be Congressional clarification of independent contractor status.

92-826 O - 96 - 4

H.R. 1972, introduced by Congressman Christensen and cosponsored by Congressman Kim, both of whom addressed this subcommittee earlier today, addresses the problems faced by the construction industry. H.R.1972 has been endorsed by Associated Builders and Contractors as well as many other organizations advocating the proper utilization of independent contractors. This bill clears up the fog surrounding the 20-factor test and replaces it with a clear-cut option for businesses.

I cannot understate the value to our nation of strong relationships between small businesses and independent contractors. Independent contractors are not only useful for businesses like mine, they are also the seeds of new small businesses.

I thank you for your subcommittee's attention to this important matter. On behalf of Associated Builders and Contractors, I offer any assistance we can give you to resolve this issue.

This concludes my prepared testimony. I believe that, as someone who actually uses independent contractors on a regular basis, my greatest use to you may be to make myself available to answer any questions you may have.

TESTIMONY

of

RAYMOND PETER KANE
President
Pisa Brothers Travel Service

Before the U.S. House of Representatives
Small Business Subcommittee on Taxation and Finance
on
Independent Contractors

July 26, 1995

Inquires to:
Raymond Peter Kane
President
Pisa Brothers Travel Service
630 Fifth Avenue
New York, New York 10111
Phone: 212-265-8420

John C. Bennison
Vice President, Government Affairs
American Society of Travel Agents
1101 King Street
Alexandria, VA 224134
Phone: 703-739-2782

TESTIMONY OF RAYMOND PETER KANE

Madam Chairman, it is an honor and a privilege for me to appear before the House Small Business Subcommittee on Taxation and Finance today. I am pleased to have the opportunity to comment on the independent contractor issue and the two bills before the Subcommittee. This legislation would have a positive impact on the thousands of travel agency owners across this country.

My name is Raymond Kane. The name of my travel agency is Pisa Brothers Travel Service which is located in New York City and was founded in 1924. I have owned and managed the agency since 1962. I also come before the Subcommittee today as a long-standing member of the American Society of Travel Agents (ASTA).

ASTA is the world's largest and most influential travel trade association with over 25,000 members in 136 countries. Our members in the U.S. represent some 12,300 travel agency locations. Sixty percent of the agencies are owned by women (many of these women started as independent contractors which enabled them to have their own businesses and accumulate the capital necessary to own an appointed travel agency) and 85 percent of the employees are women. Eighty-two percent of our members employ less than ten people. A majority of the travel agencies in the United States utilize the services of independent contractors. Over the years, agents have received mixed decisions from federal and state tax auditors as to the status of their independent contractors. Since we are clearly small businessmen and women, we have had little or no recourse to challenge those audits.

In the 1970's, in accordance with a widespread industry practice, Pisa Brothers began renting space to independent contractors in exchange for a percentage of the commissions that they earned from the travel bookings of their clients. This enabled these entrepreneurs to set themselves up in business without a large capital investment and enhanced the earnings of my travel agency. During all of this time, we have scrupulously issued 1099's, reporting all income of the independent contractors to the Internal Revenue Service and have abided by every one of the twenty guidelines that the IRS issued.

In August 1991, I received a notice from the IRS that they wanted to conduct an audit for the fiscal year 1989. This audit took place over a period of several months and resulted in a finding on February 18, 1992 of "no change," which, as you know, means that the auditor found nothing wrong.

During the six months that the IRS auditor was in my office, the contracts between my agency and independent contractors were carefully scrutinized and found to be in compliance with the IRS regulations regarding independent contractors, as indicated by the "no change" finding.

Two years later, with no change in the IRS rules and no change in my contracts with the independent contractors, the IRS has decided that these same independent contractors were really not independent contractors all along and were always employees. For the years 1992, 1993 and 1994, the IRS is demanding $274,000 in penalties.

How can you defend yourself against actions like this when the findings of the IRS on such an important matter can vary from individual IRS agent to individual IRS agent?

In my industry, independent contractors are the most productive people. They are typical of small business people who will go to any lengths to satisfy their customers to build their

"following," because this is their livelihood. Actually, the IRS probably collects more tax revenue, due to the existence of these private contractors, than if the same people were regular employees doing a routine job without the incentives that come from private ownership of their own business.

There is also a moral question here. These people have the right to be independent contractors. The IRS wants to deny them this right, not because they are not paying their taxes, but because it is easier for the IRS to monitor their payments as employees. If the IRS has a compliance problem collecting taxes from independent contractors, it should deal with this problem on its own merits and not try to change it to a classification problem in order to deny these people their right to be entrepreneurs, simply for the convenience of the Internal Revenue Service.

In light of the recent actions taken by the major air carriers to cap travel agent commissions, this effort to simplify the definition of an independent contractor will be vital to us as more and more travel agency owners look toward independent contractors to develop additional sources of revenue.

In conclusion I hope you will support H.R. 1972, Congressman Christensen's bill rather than H.R. 582 or H.R. 1083 because, in my opinion, H.R. 1972 is drafted in such a way as to provide the best protection for independent contractors. It clearly states the criteria that must be met to be classified as an independent contractor. This is so important if we are to remove the current confusion in the market place.

Thank you. I would be delighted to answer any questions you or the Subcommittee members may have at this time.

Statement of Congressman Jay Kim (R-CA)
House Subcommittee on Taxation and Finance
July 26, 1995

Madam Chairwoman, members of the Subcommittee, thank you for the opportunity to testify here today. I believe that independent contractor reform is the ultimate small business issue, so I am extremely pleased that you have chosen to have this hearing.

As many of you know, I used to own and operate a business. I ran a small engineering firm in Southern California called JayKim Engineers which, at one point, had 150 employees. Over the years my firm used many independent contractors -- accountants, consultants and others. I know from firsthand experience exactly how confusing, ambiguous and arbitrary the current worker classification rules are.

In my short time as a Congressman, I have learned that I was not alone in having difficulties with worker classification rules. I have heard horror story after horror story from my constituents about how they hired someone they thought was a legitimate independent contractor, only to have the IRS swoop in years later, claim that the worker (or workers) should have been an employee, and impose massive fines and back taxes. Often, these businesses are faced with severe financial problems and, in some cases, bankruptcy as a result of an honest mistake in classifying workers.

For this reason, I was not surprised to see that the White House Conference on Small Business identified independent contractor issues as the #1 issue for small businesses. I think that this statement should serve as a clarion call for all of us who care about the future of small businesses in this country.

The independent contractor issue illustrates one of the fundamental truths of our government: Wherever Congress leaves ambiguity in the law, a federal agency will use the ambiguity to usurp as much power as possible.

And that is exactly what the IRS has done with the worker classification rules. There exists an abundance of anecdotal evidence to suggest that the IRS consistently interprets these rules in the most restrictive way possible. The IRS is clearly not "neutral" on whether or not a worker is an employee or an independent contractor. The fact is, the agency has a bias against the independent contractor status, and as a result, puts the burden of proof on the taxpayer to prove that the worker is <u>not</u> an employee.

In short, the IRS has taken an extremely aggressive and hard-line stance on independent contractor issues -- and it has gotten more aggressive every year. Between 1987 and 1990, for example, the IRS' Employment Tax Examination Program (ETEP) grew from a

small pilot program to a major undertaking which, in 1990, employed 19,000 revenue officers who examined more than 20,000 tax returns. These reclassifications resulted in $111 million in assessments against small businesses. That's $111 million dollars that could have been spend to hire more workers, to make capital investments, or to open new businesses. And this cost figure does not even include the tens millions of dollars that small businesses must spend every year on legal fees to defend themselves against IRS prosecution.

Given these facts, it would be easy to blame the IRS for the problems in our worker classification system. But, to be honest, I really think that most of the blame does not lie with the IRS, it lies with Congress.

The fact is, despite the massive heartburn that worker classification rules have caused small businesses over the years, Congress has done almost nothing to clarify the distinction between employees and independent contractors. The passage of Section 530 in 1978 helped, but it was only supposed to be a "stop-gap" measure. When this measure was passed, it was expected that Congress would return to independent contractor issue in short order to fix the problems that necessitated Section 530. Unfortunately, Congress never did, and the problems that small businesses face in dealing with the worker classification rules have gotten much, much worse.

And the unfortunate fact is, these problems will continue to get worse until Congress gets involved with the independent contractor issue. In the absence of a clear definition of who is and who isn't an independent contractor from Congress, the IRS will continue to take advantage of ambiguities in the law to harass honest small business owners.

For this reason, I strongly believe that it is time for Congress to get off of the sidelines and reform the worker classification system. That is why, last January, I introduced H.R. 582, the "Independent Contractor Tax Fairness Act". The idea behind H.R. 582 is simple: It is time for Congress to establish a clear, unambiguous test for what constitutes an independent contractor.

To that end, the core of my bill is a simple test that establishes who is not an employee. The test has four criteria that are based on common-sense requirements for who qualifies as an independent contractor. If a worker meets any one of the four -- and has signed a written agreement clearly stating that both parties understand the responsibilities of independent contractor status -- then he or she cannot be considered an employee and the IRS is prevented from reclassifying the worker (and assessing associated fines and penalties).

In short, H.R. 582 establishes clear, easily understandable criteria for determining whether a worker is or is not an employee. Instead of having to wade through the current swamp of worker classification rules, most small businesses can look for guidance and protection

to the four common-sense criteria established by the bill. In doing so, I believe that H.R 582 would help small businesses by providing badly needed clarity to the worker classification rules.

At this point, I would like to make a couple of points about H.R. 1972, the independent contractor bill established by our freshman colleague, Mr. Christensen.

Many of you will note that I am an original cosponsor of H.R. 1972. I support this bill because I believe that, at their core, both H.R. 1972 and my bill, H.R. 582, share the same underlying intent: To establish a clear and unambiguous standard for who is not an employee. In fact, the tests established by both bills are extremely similar -- although the test in Mr. Christensen's bill is slightly more flexible in its application.

Where our bills differ, however, is in whether and how they address other important problems with our worker classification system. H.R. 582 builds on the same foundation as H.R. 1972, but also contains a more comprehensive attempt to address many of the other underlying problems with the worker classification rules. To put it simply, H.R. 1972 is the minimum we should do; H.R. 582 represents a broader overhaul of the worker classification system.

For example, H.R. 582 makes badly needed changes to the so-called Section 530 rules that help businesses who make honest mistakes in classifying workers. More importantly, the bill contains strong compliance provisions which would encourage independent contractors to more completely report their income. These most important of these compliance provisions would require independent contractors to "line-list" 1099 income. This would allow the IRS to detect unreported payments and, in doing so, improve income reporting among independent contractors.

In addition, the bill increases the penalty for not issuing 1099's to workers. According to a recent GAO study, issuing a 1099 to a worker dramatically improves the chances that an independent contractor will report their income. H.R. 582 would help ensure that 1099's do indeed get issued. Finally, H.R. 582 requires the IRS to undertake a substantial education campaign to inform businesses about the changes made by the bill.

In short, H.R. 582 takes a balanced approach to the independent contractor issue. It substantially clarifies worker classification rules and gives businesses better protection from being persecuted for honest mistakes -- making it easier and less risky for businesses to use independent contractors. In return, however, the bill requires that businesses and the independent contractors they hire are more accountable for the income that is generated as a result of their professional relationship. I believe that this is a very fair trade.

To sum up, I believe that H.R. 582 represents a balanced and comprehensive attempt to address the problems in the worker classification system. I would urge this committee, as well as the Ways and Means Committee, to consider adopting such a comprehensive approach to this issue. Since Congress will probably only have one chance in the near future to deal with independent contractor issues, I believe that we should be as thorough as possible in reforming the system.

Whatever approach we take, however, I believe that the independent contractor issue must be dealt with, and soon. There are few issues which are having more impact on the lives of small business across the country. It is my hope that, with the new Republican Congress, we can act quickly to remove this onerous regulatory burden from the backs of small businesses.

Madam Chairwoman, I would like to thank you again for the opportunity to testify today. I look forward to taking any questions you or the committee may have.

TESTIMONY OF LOCKWOOD PHILLIPS
PUBLISHER OF THE *CARTERET COUNTY NEWS-TIMES*
MOREHEAD CITY, NORTH CAROLINA

ON BEHALF OF

THE NATIONAL NEWSPAPER ASSOCIATION

BEFORE THE HOUSE COMMITTEE ON SMALL BUSINESS
SUBCOMMITTEE ON TAX AND FINANCE

JULY 26, 1995

TESTIMONY OF LOCKWOOD PHILLIPS
PUBLISHER OF THE *CARTERET COUNTY NEWS-TIMES*
MOREHEAD CITY, NORTH CAROLINA
ON BEHALF OF THE NATIONAL NEWSPAPER ASSOCIATION
BEFORE THE HOUSE SUBCOMMITTEE ON TAX AND FINANCE
JULY 26, 1995

INTRODUCTION

I want to thank Chairwoman Linda Smith and the members of the Subcommittee on Tax and Finance of the House Committee on Small Business for enabling me to present the community newspaper view of the independent contractor problem on behalf of the National Newspaper Association today. My name is Lockwood Phillips. I am the publisher and manager of the Carteret County News-Times, in Morehead City, North Carolina. I am also a member of the Board of Directors of the National Newspaper Association. The National Newspaper Association is the oldest and largest (in terms of members) national newspaper association in the United States. It was established in 1885 and has more than 4,200 community newspapers as members. These include most of the weeklies and more than one-third of the daily newspapers in the country with a focus upon newspapers serving smaller markets and communities.

I am here today to bring to your attention to IRS harassment of newspaper carriers. Many Members of Congress probably had their start in business as newspaper carriers. The time honored "Junior Merchant " program lives on today. But in 1995, newspaper carriers are typically adults. These adults, who are independent businesspersons, are being unfairly targeted by the IRS. The typical newspaper carrier is a classic entrepreneur -- a business person -- not an employee. He or she operates as a business, delivers newspapers on route by contract, files taxes

as a business and offers services to a variety of customers. However, the carrier business is threatened by rampant and subjective IRS enforcement. As Daniel Webster said before the Supreme Court in 1819, "An unlimited power to tax necessarily involves the power to destroy." McCulloch v. Maryland, 4 Wheaton 316 (1819).

We applaud the Subcommittee's efforts to find a solution to a problem that affects nearly every small business in America and is of vital importance to our members. We would like to work with your Subcommittee to find a resolution to the tangled web of IRS interpretations and regulations regarding the definition of an independent contractor and make it clear what the IRS chooses not to see: that the typical newspaper carrier is a classic entrepreneur -- a business person -- not an employee. We also wish to stress the importance and value of the small newspaper that at times is the only information provider for America's heartland. The community newspaper is operating on a thin edge of financial survival. Further subjective interpretations by the IRS regarding independent contractor status will force many of these critically important, independent voices out of business.

COMMUNITY NEWSPAPERS AND THE SMALL TOWN

Allow me to elaborate. In a small town like Morehead City, North Carolina, where I am from, contractors are vital to the economies of small communities, and to the economic life of local newspapers.

These are small communities where everyone knows each other by their first name. Imagine you live in a house in the middle of a small town. You may receive your community weekly delivered by one carrier, a community daily by another carrier, and a daily shopper by another, and even a metropolitan daily from a nearby city by still another. You also may

occasionally get flowers and dry cleaning delivered by someone else. Delivery services make small town life possible, but more importantly, they offer a livelihood to its citizens. Many times there are no large companies offering full-time employment, so you work part-time at the local bookstore, you fix chimneys and deliver wood during the winter, and you take pictures of local events and sell them to the local daily paper for extra money. You may even deliver the Saturday edition. You enjoy living in your small town. You do not want to seek fortune and fame in a large city. So you enjoy the independence of running your own business and you get by, just as many of the small businesses in your town do.

Suddenly, you face a hefty IRS assessment for failing to pay income taxes. The IRS has decided your business isn't really a business and wants you to pay for multiple sins on your tax form. How will you pay? How will this affect your newspaper since it cannot rely on you to deliver it anymore? The newspaper can also face heavy fines and penalties -- perhaps heavy enough to drive it out of business. What will happen to your community without its newspaper?

IRS ACTIONS AGAINST NEWSPAPERS

Let me give you an example of something that really happened. Recently, the IRS targeted a newspaper carrier, a man at the end of his working career, with an audit of his business expenses. He was assessed nearly $10,000 in back taxes for the previous three years, a period when the IRS claimed that the carrier was an employee and that certain expenses were not deductible. Yet the newspaper he delivered, *Rochester Post Bulletin* (MN), has written contracts and followed not only what it thought were IRS rules, but was careful to avoid exercising control over delivery. It appropriately filed 1099's for the carriers as the IRS requires. It treated the carriers in all instances as contractors. The IRS denied the independent contractor

status because, among other things, it found that the subscribers pay for their subscriptions at the office, rather than directly to the carrier. Despite the fact that the carrier was clearly compensated on a contract basis and behaved in all respects as an independent business, the IRS chose to see an employee there and determined the payment arrangement overrode the other factors. Newspapers frequently have Pay in Advance (PIA) systems, or permit payments to be mailed to the company directly, but carriers are still paid on a per-piece basis or on a flat-rate basis, not by a salary or hourly wage. These carriers operate in true independent fashion. Many in fact deliver a daily paper and then go out again with a competing weekly, something no employee could do.

Another example comes out of Washington, Pennsylvania. In 1993, the controller of the morning *Observer Reporter* received a call from an IRS agent stating the paper's federal employment tax returns, Forms 940 and 941, had been assigned to him for review. In a follow-up letter, he asked the controller to provide photocopies of the following documents for the tax year 1992: form 1120; Forms W-2, W-2C, W-3, W-3C, W-4, and UC2; contracts between businesses and independent contractors; Forms 941, 1099, 1096; invoices from independent contractors; general-ledger pages; cash-disbursements journal; form 1099 payment journal; and canceled checks.

The newspaper's controller and general manager met with the IRS agent for several hours. Before leaving, the agent told them he was going to classify 50 motor carriers as employees. In the past two years, the newspaper's top managers, accountants, and tax lawyers have spent hundreds of hours struggling with its outcome. On May 18, the IRS appeals officer presented the newspaper with a bill for $60,000 for one year and promised it a safe harbor. As I am sure the

Subcommittee knows, the "safe harbor" is a showing that the questionable activity is a long-standing practice of a significant segment of the industry. A $60,000 harbor is a pretty costly one, something most community newspapers could never afford. The publisher of the newspaper has detailed his impression of this experience in a letter to the Subcommittee, which I attach to my written testimony.

A third example comes from yet another newspaper in Minnesota, which asked not to be named, as its carrier has been intimidated by the IRS. In this case, the carrier was delivering not only a daily newspaper and a weekly newspaper, but materials for a local bank. He was following the rules, he thought, and the newspapers thought they were also following the rules. Yet his contractor status was denied, and he was ordered to pay $3,000 in back taxes. Among the grounds of denial was the assertion that he did not participate in the making of the product he was delivering. Presumably, the IRS believes a contractor who delivers cake for a bakery must also bake the cake. We find this example absurd -- particularly after we learned the person's status as an independent contractor for the bank was allowed, even as his status as a paper carrier was denied. You can understand why we believe we are being targeted.

There are many such examples that are a result of the IRS 's subjective rules on the differences between an independent contractor and an employee, applied arbitrarily. Even the IRS admits it can draw no bright line between a contractor and an employee. If the taxing agency cannot explain the rules, how can a common citizen follow them? The current law provides a 20-factor test based on common law to determine whether a company exercises sufficient control over a service provider to establish an employee-employer relationship.

Now I am not going to take the Committee's time to list these factors, but let's just say they have led to uneven enforcement, at best. Are these separate factors? Are they to be taken as a whole? Does an IRS agent pick and choose which factor to apply? A small business is required to hire a team of attorneys and accountants to figure out the safest approach in dealing with contractors. I don't know of any small business that can afford to do this. Despite a plethora of seminars and workshops to help us figure out what we must do, many of us live in fear of the IRS's power to destroy. What about the time-honored test of lack of control which served this legal question well until recent years? One supposed saving clause of this 20-factor test is the "safe harbor," but even it comes at a price, as our Pennsylvania colleague found.

Even with this safe harbor, the IRS is still harassing the newspaper industry - particularly our small members. As one newspaper attorney said, "It's very simple. They (IRS) adopt a scorched earth policy. They've never met an independent contractor -- they're all employees." Our experts tell us that in about nine out of 10 cases, the IRS finds persons classified as independent contractors should be reclassified as employees. Since about 90% of all daily newspapers and many weekly newspapers use independent contractors to sell or distribute newspapers to home delivery subscribers, it makes a fat target for the IRS.

LEGISLATION BEFORE THE SUBCOMMITTEE

Our association believes the Christensen bill is an excellent starting point for resolving our concerns. It properly begins to define that all-important bright line to resolve the current uncertainty, discourage rampant harassment of taxpayers and recognize the legitimacy of independent contractors. While we are not prepared to offer specific language for the bill at this time, we would like to work with the committee to ensure that truly independent newspaper contractors are covered by this bill.

Among our concerns are these:

1. A newspaper carrier's significant investment -- the very tool that enables him to do his job -- is his vehicle. From the viewpoint of the typical sole proprietor delivery person, that investment is very significant and the bill should recognize its significance. The significance of an investment should be measured against the contractor's capacity, not by an arbitrary measurement.

2. While some carrier contractors may be paid on a commission basis, most are paid on a flat fee basis or on a per piece basis. We are concerned about covering this method of compensation in the bill.

3. The criterion for maintaining a principal place of business would be a problem for many delivery people. Their place of business is their car, in most cases, and there is no need for any more fixed facility.

We would like to emphasize that newspapers typically are zealous in complying with IRS rules as we traditionally understood them. Writing good contracts, filing 1099 forms and adhering to the rules of control have been the subject of many training sessions in our business. Encouraging contractors to develop other business -- particularly delivery business -- is something that is almost second nature.

We are diligent taxpayers. In fact, the newspaper business is one of the largest taxpayers, collectively, of any industry in the United States. In this case, we are simply being harassed, and even more sadly, our carriers are being harassed. The community newspaper and its contractors are among those least able to withstand the grueling test of litigation the IRS often forces upon us. As I mentioned earlier, the community newspaper operates on the thin edge of financial survival. Such litigation often threatens the newspaper's survival and the survival of the community's only independent voice.

CONCLUSION

We applaud the Subcommittee for this healthy airing of views and for its groundbreaking work in taking on a terribly important problem. The National Newspaper Association looks

forward to working with you to further develop the legislation to bring clarity to what is now a very confusing and threatening situation. We want to make plain what the IRS chooses not to see: that the typical newspaper carrier is the classic entrepreneur, a business person, not an employee. Carriers are critical to community newspapers and as deliverers of other products they hold together small communities like Morehead City, North Carolina. Thank you.

OBSERVER PUBLISHING COMPANY
122 SOUTH MAIN STREET · WASHINGTON, PENNSYLVANIA 15301
PHONES AREA 412 WASHINGTON 222-2200 · WAYNESBURG 627-3131

Observer & Reporter
SERVING WASHINGTON AND GREENE AREA

July 22, 1995
To: House Committee on Small Business
Subcommittee on Taxation and Finance

The 1993 audit of independent contractors was unlike any audit we have had before. In good faith, we spent considerable time gathering the requested documents. As we have done in the past, we made available to the agent the necessary key and supportive personnel to make his job easier.

Unfortunately, it quickly became obvious that the agent and his home office in Pittsburgh, had already, without seeing any documents, determined that all our adult newspaper carriers and motor route drivers would be employes, not independent contractors. The audit, in spite of a mountain of documents to wade through, was amazingly brief.

The consequent report was not a surprise even though we met the 20 point test for independent contractors. Subsequent conferences achieved the same result and the same impression. The good faith, open, and honest manner in which we approached this audit was not reciprocated by the service.

Later, in talking with other small (20 to 40,000 circulation) newspaper publishers in Pennsylvania, we discovered the same pattern. We felt this was an abuse by the service. Since then, we have discovered that numerous other newspapers across the country have gone through similar experiences. Regardless of documentation, meeting the 20 point standard established for years, the IRS has, by executive action, simply declared that all adult carriers are employes.

Our case, and those of four other Pennsylvania newspapers, is now in the hearing stage. We have already spent thousands of dollars each for legal fees, not to mention time. Should we be required to challenge this in tax court, the costs will reach six figures. These are wasted and unproductive dollars. Some won't be able to bear this cost. Some smaller daily and weekly newspapers could not meet the economic challenge, in dollars or time, of fighting the IRS through this stage.

Interestingly, the state of Pennsylvania, in case after case involving unemployment compensation and workers comp, has recognized the independent contractor status. So has the IRS in rulings in other parts of the country.

Having adult foot and motor route carriers as independent contractors, is not a recent practice in the industry. In the 40 years or so that I have been in business, it has been so. They buy our papers and sell them to customer, or drop bundles for a fee, and use their own equipment and get their own substitutes. They are free to work for whomever they please and charge what they please(subject to customer acceptance). While reliable, many would not get through the normal employe screening process.

To reclassify them as employes would be devastating to them as well as us. Many would not be hired, routines would be drastically changed, routes abbreviated, many would be merely part-timers. We do, by the way, have full time and part time drivers who use our equipment to deliver bundles and perform numerous other tasks.

Economically, if each of our 40 or more deliverers were reclassified as employes, it would add between $5,000 and $6,000 per person to our costs. This would be a tremendous blow leading to layoffs and major cut backs in employment and service. Some smaller newspapers would cease publishing, or be unable to provide rural service at all.

For our industry, the 20 point test has worked well. It is not particularly confusing, it is practical, and flexible. It preserves job opportunities for thousands who otherwise might not be hired, or who simply want the independence of working for themselves.

We recognize that the IRS's job is to collect money. We expect them to do their job thoroughly and efficiently, but without hidden agendas and without abuse. We recognize also that the federal government wants more tax money, more medically insured citizens and so forth. We don't think, however, that we should attempt to balance the budget on the back of newspapers or independent carriers, or by forcing thousands to surrender their independence to business and industry.

The independent contractor "problem" exists, if at all, in some relatively isolated situations that clearly fall into grey areas. In our case, if there is a major problem, it is one created by the service, not us.

Thank you for the opportunity to be heard.

Sincerely,

W.B. Northrop
co-publisher

ADDENDUM TO:

TESTIMONY OF LOCKWOOD PHILLIPS
PUBLISHER OF THE *CARTERET COUNTY NEWS-TIMES*
MOREHEAD CITY, NORTH CAROLINA

ON BEHALF OF

THE NATIONAL NEWSPAPER ASSOCIATION

BEFORE THE HOUSE COMMITTEE ON SMALL BUSINESS
SUBCOMMITTEE ON TAX AND FINANCE

JULY 26, 1995

Daily Herald

July 24, 1995

The Honorable Linda Ann Smith
Chairwoman, Subcommittee on Tax and Finance
Small Business Committee
House of Representatives
Washington, D.C. 20515

DANIEL F. BAUMANN, *President*

Dear Chairwoman Smith:

I understand your subcommittee will be considering the impact IRS treatment of independent contractors has on small business, and I wanted to tell you our experience. It is an example of IRS harassment that could threaten the independence of one of a dwindling number of family-owned newspapers left in America.

Regarding our independent-contractor newspaper carriers, we have made a conscientious effort to satisfy the 20 factors used by the IRS to interpret the traditional common law rules. We know this is a very important matter. Nonetheless, an IRS auditor who visited us last year argued that we satisfy only one of the 20 IRS factors - our carriers are not full-time workers. To arrive at this decision, simply, he had to twist the truth. Denying us independent contractor status, he went on to deny us Section 530 relief because of the method we used to convert from youth to adult carriers. Next the agent imposed a 10 percent fine for failure to deposit. He capped off his witchhunt with an additional 20 percent penalty, claiming we had acted in reckless disregard of our tax liability, despite the fact that we had faithfully filed 1099 forms on all our contractors.

In all, he assessed us $5.6 million for two tax years.

The auditor's review was totally one-sided and unfair. We have concluded the real purpose behind this attack is to go after smaller, independent newspapers, as the IRS has done in Pennsylvania, Minnesota and other states, because they are least able to withstand the costs of defense. We are a proxy for even bigger game. Our appeal of this judgment will go before an IRS appeals officer in September. We can only hope he will be fair-minded, because litigation will be costly. Legal costs are a mounting burden, and there is no way to tally the untold hours of distraction and anguish this has caused.

We are pleased that the subcommittee is considering legislation in regard to independent contractors. We have reviewed legislation currently before the House, including H.R. 1972. In its present form, H.R. 1972 does not fully address the concerns of our newspaper or the industry, and we hope that in its final form those concerns will be resolved.

Sincerely,

Daniel F. Baumann

Paddock Publications, Inc.
Post Office Box 280
Arlington Heights, Illinois 60006
Telephone (708) 870-3600
Fax (708) 818-9181

SMALL BUSINESS
LEGISLATIVE
COUNCIL

STATEMENT OF THE

SMALL BUSINESS LEGISLATIVE COUNCIL

ON INDEPENDENT CONTRACTOR CLASSIFICATIONS ISSUES

COMMITTEE ON SMALL BUSINESS

U.S. HOUSE OF REPRESENTATIVES

JULY 26, 1995

1156 15th Street, N.W. - Suite 510 Washington, DC 20005 (202) 639-8500 / FAX (202) 296-5333

The Small Business Legislative Council (SBLC) is a permanent, independent coalition of nearly one hundred trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, tourism, and agriculture. For your information, a list of our members is enclosed.

We look forward to discussing the issue of the appropriate public policy with respect to the determination of an individual's status as an employee or independent contractor for the purposes of Federal employment tax law. In my oral presentation, I will address the questions raised in your letter of invitation and provide additional information on specific problems encountered by SBLC member associations' small business members as they struggle with the current situation.

In this written statement, we would like to set down a different course and suggest the philosophical underpinnings for this debate. For far too long, the prevailing sentiment in Congress has been to challenge small businesses for their use of independent contractors, rather than an analysis beginning with an examination of the ***benefits that flow from promoting independent contractors and entrepreneurial activity.***

As you know, the delegates to the recent White House Conference on Small Business made the establishment of reasonable guidelines for the classification of individuals their number one issue. The recommendation is as follows:

> "The definition of an independent contractor must be clarified. Congress should recognize the legitimacy of an independent contractor.
>
> a) The 20-factor test is too subjective. The number of relevant factors should be narrowed with more definitive guidelines for implementation. (Realistic and consistent guidelines need to be established for IRS auditors, courts, employers and state agencies.) Realistic and consistent guidelines should be

established which require one of four criteria plus a written agreement. The criteria are (1) realization of profit or loss; (2) separate principle place of business; (3) making services available to the general public; or (4) paid on a commission basis.

b) Safe harbor provisions should be established which would protect the hiring business from the burdensome penalties currently being assessed by the IRS. De minimis rules based on dollars paid, hours worked, years in business, and/or specified closed-end projects should be established.

c) Reporting compliance could be achieved by the filing of an IC-99 form (new), which would document the independent contractor relationship to the IRS and both parties.

d) The IRS should eliminate back taxes for misclassification when Form 1099s are filed and there is no evidence of fraud.

This is not a new problem for the small business community. The delegates to the 1980 White House Conference on Small Business agreed there was a need to articulate a small business "bill of rights." Their recommendation, while not expressly addressing the independent contractor issue, established a framework for why encouraging independent contractors to pursue the American Dream is essential to our economy and society. They said:

> "The American Dream is to be an owner of one's own business. Almost everyone has had the dream, and millions of Americans have lived it. The American Dream is the cornerstone of our 200-year-old American Heritage and also is the reason for our country's position as the most economically powerful nation in the world today. Could we have achieved this status as a nation if we had not been presented with opportunity unencumbered by government regulation? Could we have achieved this nation's status if entrepreneurs had not had the fortitude and shown the initiative to take advantage of opportunity when it presented itself? America was founded on the principle of each individual's fundamental rights, i.e., Freedom of Speech, Freedom of Religion, Freedom of the Press, Freedom of Assembly, Freedom to Bear Arms, etc., fundamentally, the Right to 'Life, Liberty, and the Pursuit of Happiness.' The Pursuit of Happiness can and does take the form of one going into business for oneself, the fulfillment of the American Dream.
>
> "Now, therefore, in consideration of the foregoing and; whereas the Small Business Community is represented by some 14 million small and independent businesses, and; whereas these 14 million businesses represent 100 million people and 58 percent of all private sector jobs in America and; whereas 97 percent of all newly-created jobs in the past seven years have been created among

these 14 million small and independent businesses representing 48 percent of America's gross business product and; whereas 50 percent of all new inventions, innovations, and patents are developed in the small and independent sector of American business...

"Therefore, be it resolved that said 14 million small and independent businesses have fundamental, inalienable, and constitutional rights:

1. ***The right to start, own, and manage a business without government interference.***
2. The right to compete fairly for capital with assurance that capital will be available for private use.
3. ***The right to reward for the risk, effort, and genius necessary to make an independent business work.***
4. The right to determine price just as the buyer has the right to buy or not at that price.
5. The right to be governed by reasonable and understandable laws set forth by elected representatives, not by bureaucratic dictate.
6. The right to be innocent until proven guilty by a jury of our peers; not by administrative edict.
7. The right to equal representation with Big Business, Big Labor, and Government on matters relating to America's economic polices." [emphasis added]"

"The right to start, own, and manage one's own business" – the American Dream. It seems like a principle we all automatically assume is as much a part of our nation's heritage as the Constitution and the Bill of Rights. After all, Thomas Jefferson's independent yeoman farmers were the forbearers of our entrepreneurial sector. Our nation is built upon a foundation of individual opportunity.

Back in the 1970's, Milton D. Stewart, the first Chief Counsel for Advocacy for Small Business, articulated the need for an economic bill of rights. In addition to the right to start, own, and manage one's own business, Stewart also asserted that the economic bill of rights should include the right to live in an economically diverse society and that all

citizens have an equal entrepreneurial right to participate in our free enterprise system, regardless of such factors as race, creed, or sex. He once observed:

> "As Jefferson realized at the nation's birth, economic independence is the only guaranty of political liberty. This country's 14 million small businesses provide 14 million sources, not only for economic opportunity, but also for that liberty. Every one of this nation's business owners can say anything he or she pleases. No one can fire these people or take their jobs away. If you spread the wealth and power in society, you inevitably spread freedom. The larger the small business sector, the more equality of opportunity we have for individuals and the safer our freedom of expression is from abuse. Small business fosters creativity and innovation. It is the bulwark against concentration and the remorseless abuses of power to which that leads."

While we seem to accept the belief that there is a right to start, own, and manage one's own business, we have never had a formal game plan to ensure that right is encouraged, promoted, and exercised. Just as an example, we might note, despite the fact there are some 20 million sole proprietors, partners, and S Corporation shareholders, Congress has chosen to permit such individuals to deduct only 25 percent of their own health care costs (soon to be 30 percent.) We ask you – what signal does that send to entrepreneurs?

To us, independent contracting is both the embodiment of the American Dream and the means by which it becomes an achievable dream. The essence of the American spirit is individual opportunity. For most "would be" entrepreneurs, the only asset they can bring to their new business is their own skills. Few small businesses start out with the venture capital, informal or formal, to open their business on day one, complete with employees, assets, suppliers, and customers. Independent contractor status is, in fact, the first step on the small business ladder. The risk of becoming an independent contractor is a very limited but direct risk. If I fail, I do not eat. I do not have the comfort of punching a time clock and knowing the check will be there on payday. But if I am a success, I do not

carry the burden of that time clock on my back. We are sure that few individual independent contractors want to remain one-person operations, but that is clearly the avenue of opportunity.

To us, it seems clear why individuals would seek to become entrepreneurial independent contractors. The choice is theirs to make, and the risks and rewards theirs to evaluate. Likewise, it is equally clear to us why the nation benefits. Not only does it reflect our heritage of individual opportunity, entrepreneurial activity brings with it innovation, creativity, productivity, and economic growth.

Therefore, the first thing Congress should do is to establish that encouraging independent contractors is consistent with our nation's economic heritage and social philosophy. Let us make it clear it is a good thing to do. All public policy should be built around the presumption that we should encourage Americans to start, own, and manage a business, not the presumption they are "misclassifications."

It is clear to us why independent contractors seek the status and why the nation benefits, but we are not convinced it is well understood in public policy circles why the availability of independent contractors is critical to the survival of other small businesses. To explain why they are a critical cog in a functioning small business economy, we must lapse briefly into public policy-speak. A service provider is an independent contractor. The service recipient is the business that utilizes them. It might be more accurate to refer to the service recipient as a service expediter, for frequently the general public or other customers are the beneficiaries of the service, not the so-called service recipient.

Nevertheless, the service recipient does benefit from the independent contractor relationship. As remains too often the case, sinister motives are attributed to the business that utilizes an independent contractor.

Most of these motives relate to tax liability. The truth is, behind most decisions to use independent contractors, you can find the word flexibility -- the hallmark of a successful small business.

In the dynamic tension between big and small business, the tradeoff is between economies of scale and flexibility. In a big business, enough work may be found to employ one individual with a particular skill or asset. If the market or technology changes, many big businesses find themselves caught with resources that are no longer productive or efficient.

On the other hand, if the work is not there for the skill or asset which the individual can provide, the small business owner is either going to tap an independent contractor or not provide the service. Too often, big businesses must try to force the market to adjust to them. In the small business sector, the business adjusts to the market. If a market or demand changes, the small business is able to adapt to it. If new skills and new technology are needed, the small business can re-tool itself for those changes. Responding sooner, faster, better, and more efficiently is what allows small businesses to survive, compete, and prosper. Utilizing independent contractors is part of that success story. Mandating that the individual be reclassified as an employee solves nothing because inefficiency and excess capacity is a quick route to bankruptcy.

At the same time, an independent contractor can maintain a standard of living and a way of life, and keep skills and assets in the marketplace available to a number of industry participants. Utilizing an independent contractor facilitates the sale of the service recipient's goods or service. Because the services or assets of the service provider and service recipient are mutually interdependent does not, and should not, lead to the conclusion the relationship should be that of employer-employee.

Sadly, the chasm between the rhetoric of embracing small business and promoting it through meaningful public policy is a wide one. This has been most evident in the government's past history on the use of independent contractors by other small businesses. In short, the policy has been to aggressively reclassify independent contractors as employees. We can only speculate as to the various reasons for this policy, but we are certain it is ***not*** based on the presumption that independent contractors represent the achievement of the American Dream.

We believe it is time for Congress to assert its leadership and establish reasonable and consistent guidelines for the classification of individuals as employees and independent contractors. It is for this reason SBLC supports H.R. 1972, introduced by Representative Jon Christensen. H.R. 1972 would establish objective criteria for determining whether an individual is an independent contractor or employee. It is a three-part test and the relationship ***must*** meet all three parts. But for two of the parts, there are subtests. In such cases, the relationship must meet only ***one*** of the subtest options in order to meet the requirement of that element of the three-part test.

Under part one, the independent contractor must meet just ***one*** of the following criteria:

1. Have a significant investment in assets and/or training;
2. Incur significant unreimbursed expenses;
3. Agree to work for a specific time or complete a specific result, and is liable for damages for failure to perform;
4. Be paid on a commission basis; or
5. Purchase a product for resale.

Under part two, the independent contractor must meet just ***one*** of the following:

1. Have a principal place of business;

2. Does not primarily provide the service in the service recipient's place of business;

3. Pay a fair market rent for use of the service recipient's place of business; or

4. Is not required to perform service exclusively for the service recipient and a) has performed a significant amount of service for other persons; or b) has offered to perform service for other persons through advertising individual written or oral solicitations such as listing with registries, agencies, brokers, and other persons in the business of providing referrals to other service recipients; or c) provides service under a business name which is registered with or for which a license has been obtained from an appropriate jurisdiction.

Under part three, there must be a written agreement between the parties.

We hope we can write the final chapters to this long simmering debate and look forward to working with you to find a solution that works for the small businesses of America.

/S3400
Enclosure

Members of the Small Business Legislative Council

Air Conditioning Contractors of America
Alliance for Affordable Health Care
Alliance of Independent Store Owners and Professionals
American Animal Hospital Association
American Association of Equine Practitioners
American Association of Nurserymen
American Bus Association
American Consulting Engineers Council
American Council of Independent Laboratories
American Gear Manufacturers Association
American Machine Tool Distributors Association
American Road & Transportation Builders Association
American Society of Interior Designers
American Society of Travel Agents, Inc.
American Subcontractors Association
American Textile Machinery Association
American Trucking Associations, Inc.
American Warehouse Association
AMT-The Association for Manufacturing Technology
Architectural Precast Association
ociated Builders & Contractors
ociated Equipment Distributors
sociated Landscape Contractors of America
Association of Small Business Development Centers
Automotive Service Association
Automotive Recyclers Association
Automotive Warehouse Distributors Association
Bowling Proprietors Association of America
Building Service Contractors Association International
Christian Booksellers Association
Cincinnati Sign Supplies/Lamb and Co.
Council of Fleet Specialists
Council of Growing Companies
Direct Selling Association
Electronics Representatives Association
Florists' Transworld Delivery Association
Health Industry Representatives Association
Helicopter Association International
Independent Bankers Association of America
Independent Medical Distributors Association
International Association of Refrigerated Warehouses
International Communications Industries Association
International Formalwear Association
International Television Association
Machinery Dealers National Association
Manufacturers Agents National Association
Manufacturers Representatives of America, Inc.
Mechanical Contractors Association of America, Inc.
National Association for the Self-Employed
National Association of Catalog Showroom Merchandisers
National Association of Home Builders
National Association of Investment Companies
National Association of Plumbing-Heating-Cooling Contractors
National Association of Private Enterprise
National Association of Realtors
National Association of Retail Druggists
National Association of RV Parks and Campgrounds
National Association of Small Business Investment Companies
National Association of the Remodeling Industry
National Chimney Sweep Guild
National Electrical Contractors Association
National Electrical Manufacturers Representatives Association
National Food Brokers Association
National Independent Flag Dealers Association
National Knitwear & Sportswear Association
National Lumber & Building Material Dealers Association
National Moving and Storage Association
National Ornamental & Miscellaneous Metals Association
National Paperbox Association
National Shoe Retailers Association
National Society of Public Accountants
National Tire Dealers & Retreaders Association
National Tooling and Machining Association
National Tour Association
National Wood Flooring Association
NATSO, Inc.
Opticians Association of America
Organization for the Protection and Advancement of Small Telephone Companies
Petroleum Marketers Association of America
Power Transmission Representatives Association
Printing Industries of America, Inc.
Professional Lawn Care Association of America
Promotional Products Association International
Retail Bakers of America
Small Business Council of America, Inc.
Small Business Exporters Association
SMC/Pennsylvania Small Business
Society of American Florists
Turfgrass Producers International

1156 15th Street, N.W. - Suite 510 Washington, DC 20005 (202) 639-8500 / FAX (202) 296-5333

Internal Revenue Service

Internal Revenue Service Center — Western Region, Fresno, California

Department of the Treasury
P.O. Box 12866, Fresno CA 93779

Person to Contact:

Telephone Number:

Refer reply to:

Date:

Based upon the information contained on your Form 1040, we have determined that filing a form Schedule C is inappropriate in your situation. Tax return information indicates that you are not self-employed. The fact that an individual may have W-2's from numerous employers or information returns Form 1099 from the same employer or different employers, does not alter the employee-employer relationship you have with each employer nor does it qualify you as a trade or business.

Some general requirements are:

- The business must be a "sole proprietorship", not a partnership or corporation.
- The taxpayer must be the sole owner of the business. It would not exist without the taxpayer.
- The taxpayer must be self-employed and not an employee.
- The taxpayer is not directed and controlled as to how to do the job.
- The taxpayer has a risk of loss because he is responsible for business expenses.
- The taxpayer offers his goods or services to the public, not just to one person or company.
- The taxpayer is a registered concern with the appropriate City or County in which they reside. Having all licenses that are required of their business.
- The taxpayer sales are supported with appropriate Sales Tax Returns filed with appropriate state and local jurisdictions.

Enclosed are the 20 Common Law Factors in determining whether a taxpayer is self-employed or an employee. These are the most basic and general applicable factors in determining employer/employee relationships.

Your return has been adjusted to reflect the correct treatment of income and/or expense reported on the Schedule C. The income items have been moved to the front of the form 1040 and the expense items disallowed. In addition, since the income, if any, is derived from a trade, self employment tax is appropriate.

Please find enclosed two copies of an audit report. Please sign and return one copy, the other copy is for your records. If a joint return was filed, both husband and wife must sign the report. If we do not hear from you within 30 days from the date of this letter we will assess the deficiency based on the enclosed report.

Should you have any questions, please write to us or you may call our office at the telephone number shown. A member of our staff can help you. If the number is outside your local calling area, there will be a long-distance charge to you. Please provide us with your telephone number and the most convenient time to call if we need additional information.

Attach this letter to any correspondence to help us reference your file. Keep the copy for your records. We have enclosed Publication 1 and 1383 which explain your rights as the taxpayer and the correspondence process.

36

Internal Revenue Service

Internal Revenue Service Center — Western Region, Fresno, California

Department of the Treasury
P.O. Box 12866, Fresno CA 93779

Person to Contact:

Telephone Number:

Refer reply to:

Date:

We have identified you as a professional tax preparer who prepared returns with the Fresno Service Center during the 1994 filing season. At least ___ of the returns you prepared had a form Schedule C attached.

We would like to inform you that during the 1995 filing season we will be reviewing tax returns with Schedule C's to ensure compliance with the tax laws. We have found a marked increase in the number of taxpayers filing Schedule C's who may not be qualified in using this schedule. We are requesting your assistance to ensure that only those taxpayers eligible to use this schedule are filing that way.

Since you prepared returns with Schedule C's, we would like to ask that all your clients be made aware of the requirements which entitle them to file this schedule. The general requirements are:

- The business must be a "sole proprietorship", not a partnership or corporation.
- The taxpayer must be the sole owner of the business. It would not exist without the taxpayer.
- The taxpayer must be self-employed and not an employee.
- The taxpayer is not directed and controlled as to how to do the job.
- The taxpayer has a risk of loss because he is responsible for the success of the business and its expenses.
- The taxpayer offers his goods or services to the public, not just to one person or company.
- Most importantly, the Schedule C must be completed in its entirety and that the correct Principle Business or Professional Activity Code be used that reflects their trade or business.
- The taxpayer is a registered going concern with the appropriate City or County in which they reside. Having all licenses that are required of their business.
- The taxpayer sales are supported with appropriate Sales Tax Returns filed with appropriate state and local jurisdictions.

As you are aware, there are 20 "factors" in determining whether a taxpayer is self-employed or an employee. Attached are the most basic and general applicable factors in determining employer/employee relationships.

If all the information on the Schedule C is not clearly stated, we may need to correspond with the taxpayer to request the needed information.

If returns that you prepare are found to be incorrect or inappropriate, there may be further contact with you.

Internal Revenue Service
210 Walnut Street Stop 27
Des Moines IA 50309

Department of the Treasury

Person to Contact:
W. R. Mitchell
Telephone Number:
515-224-0561
Refer Reply To:
C:ROE
Date:
06-12-95
Tax Period(s) Ended:
12-31-93
12-31-94

Our records indicate there may be a discrepancy in the classification of your workers for employment tax purposes. You are treating some workers as independent contractors and we feel they may be employees. Information gathered will be used to determine if an examination of your books and records is needed. In order to make this determination, we would appreciate you providing any and all cases, rulings, or any other support upon which you rely as demonstrating that your action was reasonable in treating any workers as independent contractors. This request specifically refers to Section 530 of the Revenue Act of 1978.

Section 530 states that an employer will not be held liable for employment taxes if there is a reasonable basis for treating an individual as other than an employee. Reasonable cause could exist under one or more of the following tests:

1. Judicial precedent, published rulings, technical advice or a letter ruling from Internal Revenue Service with respect to your business;

2. Past IRS audit if there was not an assessment pertaining to your treatment of individuals with the same positions as the individual whose status is at issues;

3. Long standing recognized practice in the industry in which the individual was engaged; or

4. Any other "reasonable" basis for not treating the workers as employees.

However, in order to qualify for relief from liability for employment taxes, you must have not treated any workers holding a substantially similar position as an employee for any period after 12/31/77. Finally Section 530 relief is available only if all federal returns (including information returns) required to be filed by you with respect to the worker were filed on a basis consistent with your treatment of the workers.

Only the information you submit to us in response to this request before the formal examination may be relied upon to demonstrate reasonableness under Section 530 in treating the workers as independent contractors.

If your reasonable cause is based on long standing recognized practice (#3), you need to contact us for the list of requirements needed to establish this as a recognized practice.

If we do not receive the requested information within thirty (30) days from the date of this letter, an appointment will be scheduled to begin an examination.

Please direct your responses to the following address:

INTERNAL REVENUE SERVICE
1701 48TH STREET SUITE 203
WEST DES MOINES IA 50266

Sincerely,

Stephen J. Stalcup
District Director

Enclosures:
Publication 1
Publication 5
Notice 609

Forbes

January 2, 1995

SECTION: THE INFORMER; Pg. 16

LENGTH: 142 words

HEADLINE: Artificial intelligence

BYLINE: JANET NOVACK; EDITED BY THOMAS JAFFE

BODY:

THE IRS is bragging about a computer program its artificial intelligence lab has been testing since 1990. It weighs 20 factors to decide whether a given worker should be treated as an employee or a self-employed contractor. Later this year the agency will give the software to taxpayers so they can figure out for themselves how it would rule.

Tax experts recommend you not depend on the software. The IRS doesn't like independent contractors because they aren't subject to wage withholding and reporting and supposedly cheat on their taxes. Last year, for instance, the IRS' Chicago district found folks to be independent contractors in less than 1% of the cases it decided.

"The software just reflects the IRS' biased views," says Washington lawyer John Satagaj, who represents small businesses on the independent contractor issue.

LANGUAGE: ENGLISH

Forbes

January 2, 1995

SECTION: THE INFORMER; Pg. 16

LENGTH: 142 words

HEADLINE: Artificial intelligence

BYLINE: JANET NOVACK; EDITED BY THOMAS JAFFE

BODY:

THE IRS is bragging about a computer program its artificial intelligence lab has been testing since 1990. It weighs 20 factors to decide whether a given worker should be treated as an employee or a self-employed contractor. Later this year the agency will give the software to taxpayers so they can figure out for themselves how it would rule.

Tax experts recommend you not depend on the software. The IRS doesn't like independent contractors because they aren't subject to wage withholding and reporting and supposedly cheat on their taxes. Last year, for instance, the IRS' Chicago district found folks to be independent contractors in less than 1% of the cases it decided.

"The software just reflects the IRS' biased views," says Washington lawyer John Satagaj, who represents small businesses on the independent contractor issue.

LANGUAGE: ENGLISH

TESTIMONY OF
ABRAHAM L. SCHNEIER
ON BEHALF OF
NATIONAL FEDERATION OF INDEPENDENT BUSINESS (NFIB)

Witness:	Abraham Schneier McKevitt & Schneier
Subject:	Independent Contractor Classification
Before:	House Committee on Small Business Subcommittee on Taxation and Finance
Date:	July 26, 1995

600 Maryland Ave. SW, Suite 700 • Washington, DC 20024 • 202-554-9000 • Fax 202-554-0496

INDEPENDENT CONTRACTOR TESTIMONY

Abraham L. Schneier
McKevitt & Schneier

Madam Chairman, my name is Abraham Schneier and I am a partner with McKevitt & Schneier. I am here on behalf of the membership of the National Federation of Independent Business (NFIB). NFIB is the nation's largest small business advocacy organization, representing more than 600,000 small business owners in all 50 states and the District of Columbia. The typical NFIB member employs five people and grosses $250,000 in annual sales.

I want to thank you for this opportunity to appear before you today to discuss the current proposals to reform the law for determining Independent Contractor Classification on Small Business.

Background

The issue of Independent Contractor Classification has literally vexed Congress, the IRS, and taxpayers for nearly thirty years. I first became aware of this issue when, as an IRS examining agent, I was required to utilize the existing tax law to make the determination on behalf of the government on whether an individual's status was that of an employee or an independent contractor. Subsequently, as a practitioner with one of the then big eight accounting firms, I was called on to advise clients on the same issue and assist them in making the determination on whether a specific circumstance warranted designating an individual as an employee or independent contractor and whether the clients faced a risk upon examination and the basis for a defense from an IRS examination.

Having sat on both sides of the table, I can tell you that both are being misserved by the existing law. The current law fails everyone and only serves to maintain the general misperception that those who seek status as independent contractors are seeking to avoid taxes.

Who are Independent Contractors?

If the last decade has taught us anything, it is that the traditional concept of lifetime employment by one employer is a relic of the past for most of us. In nearly every industry, including government, individuals with specific skills and training are seeking to find ways to market their skills and training in a shrinking pool of employers. For many of these individuals, being an independent business owner is a solution to transitions in their careers for either the short or long term.

Furthermore, since the realities of the workplace are changing so rapidly, it is unrealistic to have laws that inhibit or prevent individuals from seeking to find ways to begin their own businesses. The rules must be clear and flexible to permit the evolution in the workforce sweeping this country and the world.

Legislation

We believe that the legislation recently introduced by Congressman Christensen, HR 1972, goes a long way to solving the key issue in the independent contractor debate, i.e. what are the rules. Once everybody -- taxpayers and the IRS -- knows what the rules are, we can more easily focus on compliance and on under-reporting of income.

The premise of focusing the solution of the independent contractor debate on under-reporting of income, rather than on whether the lines are drawn precisely, is borne out by many at the IRS who clearly believe that the IRS has no direct interest in whether an individual is an independent contractor or an employee, so long as the individual accurately reports his or her income.

The Christensen legislation seeks to provide the individual with that choice, but simultaneously requires the service provider and service recipient to properly report all income to receive the benefits of the new safe harbor.

The following is a brief analysis of the proposal.

In general, this proposal will substitute a new set of criteria for determining whether an individual is or is not an independent contractor by providing rules on who is <u>not an employee</u>. Current law relies on 20 common law factors that do not permit a factual determination of the individuals status as it is determined on an industry-by-industry basis. In our proposal, the determination is based on whether the individual is or is not an employee, if he or she is not an employee, the individual is an independent contractor.

This new criteria may only be used if the independent contractor and the business for whom services are being performed correctly comply with income reporting rules. If the service recipient properly reports all payments for service to the IRS, then the rules may be relied upon. If all payments are not properly reported, neither the independent contractor nor the service recipient may rely upon this new rule, and must base any determination on the existing common law rules and existing case law.

General Rule

If the requirements of Section a, b, and c are met, the service provider will not be considered an employer and the service recipient will not be considered an employer.

Section (b)

The service provider or independent contractor will satisfy this Section's requirements if the individual can exhibit:

1. a significant investment in assets and/or training;
2. incurring significant unreimbursed expenses;
3. agreement to complete a project and is liable for damages and may be terminated without cause;
4. payment on a commission basis;
5. purchasing of products for resale.

This section is intended to demonstrate training and investment in the business whether the investment is in physical assets or intellectual property and training. In addition, if products are purchased for resale or on a commission, the individual is obviously risking his or her own capital and should be considered as in business.

Section (c)

The independent contractor must demonstrate the use of a principal place of business or the service provider must demonstrate the intention to offer his services to others and to be marketing his services on a regular basis. Qualifying in this section illustrates both independence and an investment in an office. In addition, if the individual has gone to the trouble of registering a trade name with the state, it is evidence of an intent to be an independent contractor.

Section (d)

A written contract must exist stating that the services are being provided and that the person will not be treated as an employee. A written contract that states the responsibilities for paying taxes by both the service recipient and service provider will help to insure compliance and awareness by both parties of their tax obligations.

Section (e)

This section prescribes that if the service recipient fails to meet his obligations to file information reporting returns, they cannot rely upon the protection in this section. They must then rely upon existing law and all of its traps.

Conclusion

Clearly this issue is causing great disruptions among taxpayers and small business owners, so much so that the issue of Independent Contractor Classification received the most votes among the sixty priorities voted out by the recent White House Conference on Small Business. Simultaneously the IRS and the General Accounting Office are increasingly concerned, as we are, that the growing rate of non-compliance in this area must be stemmed.

That the rate of noncompliance is growing should surprise no one, since no individual clearly understands the rules! In addition, the rate of noncompliance is not going to be helped by a system that is both unfair and unrealistic in its impact on a changing marketplace for employees and services.

Thank you for the opportunity to discuss this proposal with you today. I would be happy to answer any questions.

NATIONAL ASSOCIATION OF
THE REMODELING INDUSTRY
4301 North Fairfax Drive, Suite 310
Arlington, Virginia 22203-1627
703 276-7600 Fax: 703 243-3465

Statement of
Patti Burgio, Director of Government Affairs
National Association of the Remodeling Industry
submitted to Taxation and Finance Subcommittee
of the House Small Business Committee
regarding the Status of Independent Contractors
July 26, 1995

On behalf of the 6,000 member companies of the National Association of the Remodeling Industry (NARI), representing more than 40,000 home improvement professionals, I am pleased to submit testimony in support of Congressman Jon Christensen's bill, H.R.1972, the Independent Contractor Tax Simplification Act of 1995.

The status of independent contractors has been the number concern one for NARI since 1978. It is now the number one issue for the 1995 White House Conference on Small Business. We are pleased the Chairwoman has seen fit to hold these hearings, drawing greater attention to this most important small business issue.

Independent contractors are an integral part of the home improvement industry. Small business general contractors, many of whom started out as independent contractors, commonly contract with specialty craftsmen to fulfill specific aspects of a larger home improvement project. Since each remodeling project is unique, especially for full service remodeling firms, various specialty trades are needed from one job to the next. Independent contractors or subcontractors are well suited to serve in these cases. They provide general contractors with flexibility and cost efficiency in offering varied multi-service projects to the homeowner. They allow remodeling firms to meet fluctuating service demands created by short term projects and specific client needs.

For years, remodelers have struggled with the ambiguities surrounding the definition of an independent contractor. Remodeling firms have suffered financially due to the broad discretion afforded IRS agents in applying the 20 question, common law tests. Despite the Congressional moratorium issued in 1978, the IRS continues to aggressively audit and reclassify subcontractors as employees for federal tax purposes. It is obvious that a bias exists in favoring employee status rather than allowing entrepreneurs to remain in business for thems

The ramifications of a reclassification go far beyond federal withholding, unemployment, Social Security and Medicare payments. Besides back taxes, penalties and interest, remodelers are often held liable for state employment taxes, workers' compensation insurance, pension plan payments, and other employee benefits. An IRS or state employment audit often results in the unfortunate dissolution of the company.

The time is now for Congress to enact a clear, fair and objective standard that puts an end to the confusion once and for all. H.R.1972 provides the answer. This is a simple test that anyone can understand. There will be no question as to who is and who is not an employee for federal and state tax and employee benefit purposes.

We have testified in the recent past in support of such a solution. NARI member, Wayne Kaufman of United Homecraft in St. Louis, Missouri, testified this January that this issue was of primary concern to himself and his colleagues in Missouri. Mr. Kaufman is truly representative of most remodeling firms in America.

We are extremely pleased Congressman Christensen and more than one hundred of his colleagues, including the Chairwoman, have found a solution to the problem. We believe H.R.1972 is a workable bill that will provide clarity to thousands of general contractors and independent contractors. Many of the inconsistent findings and industry mistakes are made because the existing rules are so vague. This bill spells out the requirements for independent contractors and provides the greatest opportunity for entrepreneurial growth.

Subcontractors are a very independent breed. They prefer to pick and choose which projects they would like to work on. They want to be their own boss. They do not want to be employees; that is why they have struck out on their own. This bill allows that maverick spirit to flourish, creating new companies and new jobs.

Given the recommendation of the White House Conference on Small Business and the new Congressional climate, the time is ripe for Congress to tackle this issue head on and provide small businesses and the IRS with clear guidance that will allow us to easily determine who is and who is not an employee. **The first step is to enact H.R.1972.**

Second, the focus of the IRS must change to matching Forms 1099 with the actual income reported by independent contractors rather than reclassifying workers. If the subcontractors are under reporting their income, then the IRS should go after them.

Finally, compliance should be enforced consistently. It seems that the IRS likes to set an example in a community by aggressively penalizing one company, the news of which spreads like a wildfire, in hopes that other similar companies will be frightened into hiring their

subcontractors as employees. All subcontractors should not be reclassified as employees simply to benefit the IRS in revenue collections or the Administration in providing employee benefits.

We appreciate the concern of this Subcommittee and truly hope that action is taken soon to clarify the rules regarding the definition of independent contractors. It is extremely difficult for small remodeling firms to continue to operate under such a cloud of uncertainty. Enactment of H.R.1972 will go a long way in clearing the air.

NARI is a not-for-profit trade association with nearly 6,000 member companies nationwide, representing more than 40,000 remodeling industry professionals. NARI members are primarily residential home improvement contractors, and include national manufacturers and distributors of home improvement products and services.

Residential remodeling constitutes a $100 billion industry that has grown more than 130 percent in the last ten years. With more than 50 years of experience, NARI is committed to enhancing the professionalism of the remodeling industry and serving as an ally to homeowners. NARI is dedicated to the growth and betterment of the remodeling industry and related small businesses. For more information about NARI, contact Patti Burgio, director of government affairs, NARI, 4301 North Fairfax Drive, Suite 310, Arlington, VA 22203, 703/276-7600.

D.J. Lessin & ASSOCIATES, INC. • CERTIFIED PUBLIC ACCOUNTANTS

WRITTEN TESTIMONY PREPARED

BY DEBRA J. LESSIN, C.P.A.

SUBMITTED TO THE

SUBCOMMITTEE ON TAXATION AND FINANCE

COMMITTEE ON SMALL BUSINESS

U.S. HOUSE OF REPRESENTATIVES

ON CLARIFYING THE STATUS

OF INDEPENDENT CONTRACTORS

July 26, 1995
August 2, 1995

444 N. WELLS·SUITE 504•CHICAGO, IL 60610•312·321·1881•FAX 312·321·0837

D.J. Lessin & ASSOCIATES, INC • CERTIFIED PUBLIC ACCOUNTANTS

July 21, 1995

The Honorable Linda Smith, Chair
Subcommittee on Taxation and Finance
Committee on Small Business
Congress of the United States
House of Representatives
104th Congress
B-363 Rayburn House Office Building
Washington, D C. 20515

Dear Chairman Smith,

I am writing to you to comment on the upcoming hearing that the Subcommittee on Taxation and Finance is holding on Independent Contractors I would like this submitted as written testimony for the records I am a Certified Public Accountant with a practice located in Chicago that serves creative, professional and entrepreneurial individuals and small businesses throughout the United States As a CPA I can bring some technical expertise to the table As a business owner for over 12 years I also bring some practical day-to-day business experience to the realm of my professional expertise Those combined credentials also allowed me the opportunity to participate as a delegate to the recently held White House conference on Small Business I am also the original author of Issue #224 on Independent Contractors which received the most votes at the conference

I commend your committee for the timeliness of addressing this issue I sat in on the hearings held by the House Small Business Committee on January 19, 1995 since I found myself in Washington to testify before the Committee on the Home Office Deduction in the morning What I heard at the independent contractor hearings helped me shape the text of Issue #224 as some new perspectives were gained on how business owners perceive the compliance area encompassing independent contractors

As a C P A , I am often forced to be the "Tax Police", enforcing rules and regulations that do not always seem fair or logical to me That is what has spurred on my political advocacy and involvement in the small business community That involvement has been so strong this past year that I was honored by being named the Illinois and Region V Small Business Administration Accountant Advocate of the Year When it comes to independent contractors, I am a C P A who educates my clients about compliance responsibilities regarding issuing Forms 1099 annually I was surprised to hear those testifying before the House Small Business Committee that they were afraid to issue Forms 1099 because they found the fear and exposure of a payroll audit so overwhelming Perhaps my clients are not in the industries currently being targeted for such audits, but that point of view was quite new to me It is hard enough running a business with the already existing paperwork and administrative tasks involved An audit of any kind is a nightmare come true for most business owners I do not question that there is a problem with compliance if Forms 1099 are not issued But if they are issued, the IRS document matching does work If all parties report their income there truly is not lost revenue Nor do I question that certain people treated as independent contractors are probably really employees But, it has become more and more apparent to

444 N WELLS·SUITE 504•CHICAGO, IL 60610•312·321·1881•FAX 312 321 0837

me that more and more laws are being enacted because of those who abused the law or failed to comply. That means that the "good" taxpayers are punished by more paperwork and regulations to pay for the "bad" taxpayers. In and of itself, that is not fair.

Today's business environment is drastically different from that which existed five, ten or fifteen years ago. The economy and job creation is being driven by small business. And many of these small businesses are in the service sector. A service economy is drastically different from a manufacturing economy. Our tax laws and especially growth and expansion incentives tend to favor a manufacturing economy. But the reality is we will never be the manufacturing economy we once were. In a manufacturing environment, it is easier to identify who is an employee. But in a service economy, where services are being exchanged it is less distinctive. An independent contractor is essentially an entrepreneur. Thus, it makes logical sense that the 1,800 entrepreneurs gathered in Washington this June had the vision and the courage to take a stand on an issue that affects their lives and their businesses.

I commend Representative Christensen and his many cosponsors for recognizing the importance of this issue at the White House Conference on Small Business by introducing H.R. 1972. His timeliness is commendable. The participants at the conference hope that we will participate in drafting any new legislation. Bullet Point (e) of our recommendation says "Changes and implementation processes should be formulated by a joint committee of legislators and small business people." We have just started to come up for air after the exhausting process of the conference. As I find myself responding to H.R. 1972 which references our recommendation, I hope that the following comments will be taken in the spirit in which the White House conference recommendation was proposed.... that of participation and understanding. We are asking you to let us help you understand the day-to-day interactions of a small business so that a law can be formulated that makes sense and works for all parties involved.... a law where compliance will not be an issue, but where fairness is perceived for as many types of businesses as possible. Even within the service sector businesses differ as to how they make their money and the expenses they incur. It is hard to make assumptions that what applies for one business applies to another. It is also important to note that as we are becoming a "society of consultants", much of this is being promulgated by the big corporations in their continued effort in downsizing corporate America. As they terminate their employees, they often rehire them under a different arrangement as a consultant. What I have seen over and over again is that these corporations force the affected individuals to form a corporation. By contracting with the corporation, they thereby avoid problems with the appearance of independent contractors. Many people caught in the downsizing whirlwind also choose to become consultants. My concerns are only with the small business persons which would encompass the latter, but not the downsizing large corporations.

Here are the problems that I see with H.R. 1972. First, it does not replace the 20 factor test but is intended to add to the Code Section. Is this intended as a "safe harbor" provision? If so, it is clearly not the kind of safe harbor provision sought by the White House Conference participants. The 20 factor test is too subjective. IRS agents have no definitive guidelines for implementation. It is not strictly a majority

plus one test for passage. Agents will often reclassify independent contractors as employees with just one or two criteria missed. This allows no opportunity for planning and protection. Even a well-drafted independent contractor agreement between the business and the independent contractor (in which the independent contractor states voluntary treatment as an independent contractor) is not adequate protection. The White House Conference recommendation included the following one of four criteria plus a written agreement: (1) Realization of a profit or loss; (2) separate principal place of business; (3) making services available to the general public; or (4) paid on a commission basis. While H.R. 1972 seems to address some of these criteria, it does so in a way that is again subject to too much interpretation. Sec 3(b)(1) and (2) adds the word "significant" before "investment in assets and/or training" or "unreimbursed expenses", respectively. How is this defined? If this is open to interpretation, we have a problem. Again, expenses incurred by one type of business may be different than another. Sec 3(b)(4) adds the word "primarily" before "on a commission basis". The words "significant" and "primarily" are subjective words that leave too much room for consistent and realistic guidelines for interpretation. Section (c)(1)(A) refers to the service provider's principal place of business. How is this intended to apply to home-based businesses who have been caught in the nightmare of the Supreme Court "Soliman" decision. This is another issue unto itself that I have been involved with for over 2 years. It is also another White House Conference Recommendation (See NCRA #34). If this provision is intended to exclude home-based service businesses that are used for essential administrative and management activities, then it cannot have either my personal support nor the support of the conference delegates.

The one thing that is not addressed in H.R. 1972 that was talked about in detail at the conference is the broader concept of safe harbor provisions. In a perfect world all business owners would seek professional help before they begin their businesses. But, this is not a perfect world that we live in. Many businesses do not understand the value of such professional expertise and feel that the cost does not justify the result. While I know this not to be true, I feel a sense of protection of start-up businesses. We would like to see some safe-harbor provisions that would protect businesses no matter what. Suggested safe-harbor provisions included de minimis rules based on dollars paid, hours worked, years in business, and/or specified closed end projects. We offered a number of suggestions to cover the differing types of businesses. To always have to hire an attorney to draft a contract make day-to-day business operation too costly. Businesses have to judge the cost of compliance against that which is to be gained.

It is my understanding that the American Institute of Certified Public accountant (AICPA), of which I am a member, will testify on a proposed safe-harbor which calls for a 5% withholding by the payer. I am opposed to this. I want to provide professional expertise not more paperwork compliance. A larger small businesses may have the ability to implement this 5% withholding more easily. But, I honestly believe that there would be less compliance, not more with this kind of procedure. If the business has the ability to afford the additional cost of compliance, it will be protected. If it does not, then it runs the audit risk. It has gotten to the point where if I have to judge the cost of compliance against what is to be gained then there is something wrong with the law. This proposal would have been

booted out of the White House Conference meetings. My original proposal called for some additional compliance provisions and this was the first thing to be eliminated. Small business wants less paperwork, not more. We want to go about our businesses and create jobs and opportunities for other businesses without government on our backs. As long as Forms 1099 are filed, then everyone should be satisfied. With regards to the 5% withholding, certain industries would be in a no win situation if this kind of safe harbor were instituted. The profit margins in the construction industry is often less than 5%. They would have to elect not to apply this safe harbor for fear of severe cash flow problems. A safe-harbor should be designed to protect everyone, not just a few. And would those not electing the safe-harbor provision be automatic audit targets? I fear that the answer would be yes.

As far as penalties for misclassification, that is where most small businesses suffer the most. The sudden assessments of penalties can threaten the continued existence of a business. Is that what we really want to encourage? Why would we try to break the back of that which is thriving in this country. Plain and simple... As long as Forms 1099 are filed and there is no evidence of fraud, there should be no penalties.

I realize that the chances of our recommendation being implemented exactly as we wish may be difficult. But, you don't get what you don't ask for !!!! I ask you to reread our recommendation (copy follows) and allow us to further participate in the process. As individuals and business owners, we will bring a fresh, realistic perspective to the process. Not every delegate that participated in the White House Conference Taxation session was a tax practitioner... and that is good. The conference represented a cross section of business owners with many differing views. I realize that there is the fear that with a liberal independent contractor law all business owners are going to fire their employees and hire them back as independent contractors. Yes... those who abuse the law may pull something like this. But the vast majority of honest business owners value the importance of good employee relationships to their business. Laws should not be written to punish those who never abused the law because someone else did. Rather, the growth of small businesses should be encouraged by allowing us the opportunity to help ourselves and our fellow business owners grow our businesses without the constant fear that the IRS is going to get us. That is the spirit in which the independent contractor rules need to be evaluated. I trust that is how you will choose to revise the laws.. with a little help from your friends... the small business owners from the White House Conference.

Sincerely,

Debra J. Lessin

Debra J. Lessin
Certified Public Accountant

DJL/kmw/122

Taxation

224. The definition of an independent contractor must be clarified. Congress should recognize the legitimacy of an independent contractor.

a) The 20 factor test is too subjective. The number of relevant factors should be narrowed with more definition guidelines for implementation. Realistic and consistent guidelines which require one of four criteria plus a written agreement. The criteria are (1) realization of profit or loss; (2) separate principle place of business; (3) making services available to the general public; or (4) paid on a commission basis.

b) Safe harbor provisions should be established which would protect the hiring business from the burdensome penalties currently being assessed by the IRS. De Minimis rules based on dollars paid, hours worked, years in business, and/or specified closed end projects should be established.

c) The IRS should eliminate back taxes for misclassification when Form 1099's are filed and there is no evidence of fraud.

d) Congress should specifically allow employers and independent contractors to provide joint technical training and to jointly utilize major specialized tools without jeopardy of reclassification of the independent contractor to employee status.

e) Changes and implementation processes should be formulated by a joint committee of legislators and small business people. (votes received: 1471)

NATIONAL ASSOCIATION OF WOMEN BUSINESS OWNERS

July 24, 1995

1377
K St., NW
Suite 637
Washington
DC 20005

Telephone
301-608-2590
Facsimile
301-608-2596

The Honorable Linda Ann Smith, Chairwoman
Subcommittee on Taxation and Finance
United States House of Representatives
Washington, D.C. 20515

Dear Madam Chairwoman and members of the Subcommittee:

The National Association of Women Business Owners (NAWBO) wishes to comment on the upcoming Independent Contractor hearing. We request this correspondence be submitted as written testimony for the records.

First, we extend our appreciation to the Subcommittee on Taxation and Finance for their timely consideration on this issue. The White House Conference on Small Business delegates included over 250 members of NAWBO. We were an effective voice at the conference with 100% of our issue recommendations in the top 60. The top issue recommendation regarding independent contractor was modeled after the National NAWBO position paper on this issue.

This issue affects not only the employing business entity, but the service provider as well. The small business community is needing guidance and protection at both ends. The current 20 factor test does not provide for a definitive guideline in determination of independent contractor status. It must be replaced with realistic and consistent guidelines that can be determined and relied upon. Small business owners are asking for this structure. It is virtually impossible to follow the rules, when you cannot reasonably determine what the rules are. This is evident by the fact the Internal Revenue Service is putting the finishing touches on software intended to help IRS employees make employee/independent contractor determinations. The "SS-8 Determiner", as it is called, applies the 20 common law factors to evaluate worker relationships, using the factual information provided by employers on Form SS-8, Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding. IRS receives some 15,000 of these forms annually, and estimates that its new software will reduce from six hours to one, the time it takes to make a determination. They also expect the program to increase the uniformity of worker classification decisions. However, no decision has been made on whether to release the software to the public AND Revenue Agents will have the authority to override determinations made by the software in an audit. If the IRS does not have the ability to provide uniform worker classification decisions and will not be bound by their own internally developed testing software, then we ask you, what is the small business owner to do?

NAWBO has reviewed the content and wording of H.R. 1972 and extends appreciation to Representative Christensen and the many cosponsors for their support of this very important issue. We believe this is a good beginning toward a workable independent contractor provision, but also wish to express concern as to certain language in the House bill. H.R. 1972 calls for a three tier testing criteria; the subcontractor must meet the requirements of a one of five criteria, and a one of two criteria, and have a written document. The word "significant" appears three times in the testing criteria and the word "primarily" appears twice. These terms have different meanings for different industries. What is a significant investment in assets for one business is insignificant for another. They are also subject to broad interpretation.

The White House Conference on Small Business independent contractor issue recommendation requested a one of four testing criteria and written agreement for status determination in lieu of the 20 common law factors. In addition, it provided for safe harbor provisions, assessment relief provisions, and joint technical training. The most critical request of the process was that a committee of legislators and small business people be formed to work with the changes and implementation process. The National Association of Women Business Owners supports this issue recommendation and respectfully requests it be considered in its entirety.

The small business community is a substantive part of our economy. We are faced with more challenges and demands than ever imagined. With respect to the independent contractor issue, we are not asking for the merits of the relationship to be changed. We are simply asking for protection from IRS re-determination and classification using their inconsistent and subjective guidelines. We wish to abide by the rules...we simply need to be able to determine what those rules are.

Respectfully submitted,

Sherry Dale

Sherry Dale, CPA
NAWBO Vice President - Public Policy
WHCSB, Appointed Delegate - Oklahoma

Sandra Abolos

Sandra Abolos, CPA
NAWBO Taxation Issue Chair
WHCSB Region IX Tax Chair

cc: Subcommittee on Taxation and Finance

c:\wp61\publicpol\indpcont.det

STATEMENT OF DONALD GENE WADE, EA, INDEPENDENT CONTRACTOR REPRESENTING H.D. VEST FINANCIAL SERVICES

House Small Business Committee
Subcommittee on Tax and Finance

July 26, 1995

Madam Chair Linda Smith, Ranking Member Martin Meehan, and Members of the Subcommittee on Tax and Finance, thank you for inviting me to submit written testimony today on the issue voted on by 1600 participants at a White House conference on small business issues as the number one concern facing the small business community - the independent contractor issue. My name is Donald Gene Wade and I am testifying today in my capacity as an independent contractor for H. D. Vest Financial Services ("H.D. Vest").

Actually, I am testifying in a dual capacity. First, I am a small business entrepreneur in the American tradition. I own and operate my own general accounting and financial planning practice in Toledo, Washington. This is a classic small business, owned and operated as a sole proprietorship with a staff of two. We provide a wide range of financial services to a diverse, but predominately middle class, client base. Through hard work, I have built a financial services practice capable of offering diversified financial planning and investing with a strong foundation in tax preparation.

More important for the hearing today, I am an independent contractor affiliated with H. D. Vest Financial Services, which, through its 4,500 Representatives across the United States (including myself) provides financial advice to 1.5 million American families and businesses. Vest's activities include transactions involving insurance products, mutual funds, and unit investment trusts. H.D. Vest is a member of the International Association for Financial Planning and the Independent Contractor Firms Committee of the Securities Industry Association.

An American small business success story itself, H. D Vest was founded by Dr. Herb D. Vest in 1983. It has grown from a very small business to a thriving enterprise. Headquartered in Irving, Texas, its more than 130 employees help service customers in nearly every corner of the United States. H. D. Vest was listed as one of *Inc.* magazine's 500 fastest-growing companies in 1989 and 1990. Herb Vest has been profiled in *Success* and *Forbes* magazines and was recently named as one of the 100 most influential persons in the accounting profession by *Accounting Today*.

Like most H. D. Vest Representatives, I own my own tax preparation business, and did so prior to joining the H.D. Vest team. My existing client base comes to me primarily for advice relating to tax and business planning issues; as such, my business would be quite successful regardless of my affiliation with Vest. The commissions or fees I earn marketing Vest's products and services are but a supplement to my existing operation. Vest provides legally required oversight of my operation, but it competes with other firms to provide me with financial services and products to market to my clients. In essence, Vest works for me.

H.D. Vest Representatives are the ultimate independent contractors. We work our own hours, using our own equipment and staff. We work on our own schedule and cover our own expenses. And like any other small businessperson, we shoulder the entire risk of our enterprise. We are textbook examples of independent contractors.

The most important point about my relationship with H.D. Vest is that I have chosen to be an independent contractor as opposed to an employee. I like being my own boss and I enjoy the freedom that the independent contractor status allows me. I estimate that, on average, less than 20% of my time is devoted to financial planning. The other 80% of my time is spent servicing my clients' tax and accounting needs. The services I choose to offer through H. D. Vest are only a supplement to my existing operation; fees and commissions I receive related to these services make up only a fraction of my overall income.

I have three key points I would like to make in my testimony today:

1 . If changes are made in the definition of independent contractors, they must be made with care. More importantly, these changes must be legislative changes made by Congress and not administrative or regulatory changes made by the Internal Revenue Service ("IRS"). The IRS's long-standing hostility to the use of independent contractors is well-known and well-chronicled.
2. An example of the IRS' crusade in this arena is an internal directive on worker reclassification currently being redrafted within the Service. The so-called coordinated issues paper ("CIP") targets the securities industry and provides auditing guidance to IRS field agents making worker classification decisions. The paper is flawed in a number of important respects and threatens to reclassify approximately 100,000 registered representatives in the securities industry.
3. There is no bright line to distinguish between employers and independent contractors. Instead, the IRS uses 20 "common-law" factors to make determinations regarding questions of employment status. This test is unevenly applied by the IRS and difficult to predict. A clearer definition will make it easier for the IRS to distinguish between an independent contractor and an employee.

General Background

Under current law, classification of workers[1] as either independent contractors or employees is based on the application of twenty common-law factors to the workers work environment (*See,* Rev. Rul. 87-41, 1987-1 C.B. 296). These factors are all related to the extent to which an employer maintains control over his or her worker. In general, the more control an employer exercises over the worker, the more likely that the worker will be considered an employee rather than an independent contractor. According to existing regulations:

> [An employee relationship] exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is the subject to the will and control of the employer not only as to what shall be done, but how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so . . . if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is an independent contractor.

Treas. Reg. section 31.3121 (d)-l (c)(2).

Over the years, this principle has been "fleshed out" by private letter rulings, revenue rulings, case law, internal IRS guidance documents called coordinated issues papers, provisions in the Internal Revenue Manual, numerous IRS characterization decisions, and a limited number of related regulations. There exists a substantial body of law and guidance in this area.

The independent contractor issue is not new, and neither is the charge that employers sometimes abuse the independent contractor designation. Indeed, some would contend that there is an economic incentive to *mis*classify. The classification decision impacts the treatment of workers under the Federal Unemployment Tax Act ("FUTA"), the Federal Insurance Contributions Act ("FICA"), and the federal income tax withholding rules.

---

[1] In this written testimony, the word "worker" will be used to describe those persons who provide services as either employees or independent contractors.

After three decades of hearing the constant drum beat of criticism of independent contractors from the IRS, one might reach the conclusion that this is a disfavored designation. Nothing could be further from the truth. The IRS has testified that the law dictates no preference over "employees" or "independent contractors." They are simply two legitimate categories for the classification of workers. The independent contractor designation performs a legitimate function in a modern society where companies engage in a continuous stream of short-term relationships for specific tasks. The alternative is a system where everyone hired by a company -- from the temporary secretary, to the painter, to the data programmer, to the tax preparer -- must be treated as an employee.

Key Points

1. If changes are made to the definition of independent contractors, they must be made legislatively by Congress and not administratively by the IRS.

Over three decades, Treasury has made no secret of its hostility toward the independent contractor designation. In fact, remarkably, Congress has imposed a statutory prohibition against Treasury promulgating regulations affecting this area because of well-documented concerns about the IRS's overzealous pursuit of independent contractors in the past. That provision, Section 530 of the Revenue Act of 1978, was adopted after Congress received a large number of "taxpayer complaints" linked to increased enforcement by the IRS in the 1960's and 1970's and a "substantial" number of independent contractors were reclassified as employees (according to testimony by Evelyn A. Petschek of the Department of Treasury in 1992). Former IRS Commissioner Donald Alexander went before Congress in 1979 and confessed to "too effective and hard-nosed" activities by the IRS regarding audits on the independent contractor issue. Others would use stronger terms to characterize the IRS's activities in this area. If the IRS is allowed to redefine independent contractors, the ability of businesses and individuals to legitimately use the designation will be drastically limited

I would like to bring to your attention an article in the December 15, 1993 edition of the *Washington Post* on this subject. It quotes D. J. Gribbin from the National Federation of Independent Businesses ("NFIB") who said: "From a business standpoint, the last people you want writing the rule is the IRS. We think it's pretty scary." There is also a comment from John Satagaj, the president of the Small Business Legislative Council, who stated: "[The IRS has] a very strong bias toward classifying individuals as employees."

There are legitimate reasons to review and revise the definition of independent contractor. The 20 common-law factors that serve as a basis for current classification decisions are nebulous and inconsistently applied. In this case, however, it should be Congress that clarifies the definition, not the IRS.

2. The IRS's crusade against independent contractors is well illustrated by its current focus on the securities industry.

A current alarming example of the IRS's crusade against independent contractors is the Service's ongoing plan to draft internal guidelines for field agents auditing in the securities industry. The IRS is currently drafting a coordinated issues paper or CIP which, once approved, will be disseminated to its field agents throughout the United States.

The first and most obvious question is whether this CIP violates the Section 530 regulatory moratorium. Some have argued that the IRS issuing an internal directive to field agents is the functional equivalent of a regulation. Indeed, the CIP does exactly what a regulation does -- it establishes the policies and procedures the IRS will use when making worker classification decisions in the securities industry. If the CIP does not violate the letter of the law, it certainly violates the spirit of the law. Certainly from my perspective as an independent contractor, whether it is called a regulation, a CIP, or anything else, the impact on me is the same. In fact, in one sense, a CIP is worse than a regulation because there is no notice, no chance for the industry to comment on the paper, and no formal opportunity for the industry to participate in its development.

There is another alarming aspect of this issue. The draft CIP addresses the key issue in any worker classification decision -- how much control the employer exercises over his workers. The more control that is exercised, the more likely that the worker is viewed as an employee rather than an independent contractor. However, the draft guidance paper goes a step further. It says, remarkably, that if an employer takes reasonable steps to ensure compliance with existing laws and regulations, that could constitute enough control to reclassify an independent contractor as an employee. Let me state that again from my perspective. *To the extent that a conscientious small business owner like H.D. Vest takes steps to ensure that a representative like me complies with the law, H.D. Vest is increasing the chances that I will be declared an employee.* This is particularly troubling in the securities industry where employers are required to ensure that their workers - employees or independent contractors - comply with a myriad of laws and regulations.

The IRS's position defies both common sense and common law. In North American Van Lines, Inc. v. National Labor Relations Board, 869 F.2d 596, 599 (D.C. Cir. 1989), the Court of Appeals of the District of Columbia stated: "[E]mployer efforts to ensure the workers compliance with government regulations . . . do not weigh in favor of employee status." Independent contractors have consistently argued that this type of supervision should be a neutral factor in worker classification decisions. Any other approach has the effect of discouraging companies from ensuring that their workers comply with the law, a result that makes little sense. So far, however, there are no indications that the IRS plans to alter its position on an employer's duty to supervise.

Because the draft CIP is currently targeted at the securities industry, the "duty to supervise" issue would appear to apply only to our industry. Unfortunately, however, once this precedent is set in the securities industry, it will be just a matter of time before this interpretation is applied to other industries as well.

3. A clearer definition will make it easier for employers and the IRS to distinguish between an independent contractor and an employee.

The fundamental problem with the independent contractor issue is that employers have had a difficult time following IRS guidelines on classifying an individual as an employee or an independent contractor. The confusion has caused many small firms to face substantial tax penalties and interest imposed by the IRS when the Service arbitrarily determines that a business has wrongly classified an employee as an independent contractor. These fines are levied even if the mistake is unintentional, the employer reports all payments to the independent contractor, and all appropriate taxes are paid. For companies operating on narrow profit margins, misinterpreting the vague guidelines issued by the IRS can put them out of business.

Clarification of the independent contractor definition was cited as the number one concern of the small business community at a recent White House conference on small business issues. Regarding the documented concern, Jack Faris, president of the 600,000 member NFIB, said, "These active small business owners are sending a clear message to Congress -- let's clarify this role so we can get the IRS off our backs and out of our pockets." Faris went on to say that "[c]learly, the IRS confusion over independent contractors is a burning problem for Main Street America. The men and women who create businesses and provide jobs are calling on their government to redefine the rules so they can continue to expand their companies and provide more opportunities for entrepreneurs who would create businesses for themselves as independent contractors."

H.R. 1972/H.R. 582

In the announcement regarding these hearings, you requested comments on the recent legislative proposals by Representative Jon Christensen (H. R. 1972) and Representative Jay Kim (H.R. 582). While Mr. Kim's proposal is a step in the right direction, I support H.R. 1972's clearer and more definitive Congressional answer to the independent contractor question.

The Christensen legislation makes it easier for employers to distinguish between an independent contractor and an employee. Instead of seeking to define who is an independent contractor, H.R. 1972 defines who is not an employee. It establishes a clear set of criteria that must be met for an individual to perform services as an independent contractor and

provides a new approach to the non-definitive worker classification standards (the twenty common-law factors) currently in use. H.R. 1972 establishes a practical and consistent set of guidelines upon which small businesses can rely when making decisions about worker classifications. More importantly, enactment of the Christensen legislation would prevent the IRS from establishing new standards relating to questions of employment classification.

Conclusion

Thank you again for your interest in this critical issue for the small business community. The independent contractor issue goes directly and significantly to the bottom line of small businesses everywhere. It also affects my free choice to act as an independent contractor. Correcting the independent contractor classification problem will allow employers to hire independent contractors without any uncertainty. Consequently, it will allow many aspiring entrepreneurs to build their businesses using independent contractor services without fear of catastrophic repercussions involving the Internal Revenue Service's independent contractor project.

I hope you will take steps to ensure that the independent contractor issue is addressed as soon as possible. As such, I urge you to support legislation clarifying the definition of independent contractors in order to relieve the small business community from the burdens of uncertainty.

ISBN 0-16-052576-4